

# **Audit Market Structure, Fees and Choice following the Andersen Break-up: Evidence from the UK**

Shamharir Abidin  
Senior Lecturer, Universiti Utara Malaysia

Vivien Beattie  
Professor, University of Glasgow, UK

Alan Goodacre  
Professor, University of Stirling, UK

**November 2008**

Corresponding author:

Professor Vivien Beattie  
Department of Accounting and Finance  
West Quadrangle, Main Building  
University Avenue  
Glasgow  
G12 8QQ  
UK

Tel. +44 (0)141 330 6855  
Email [V.Beattie@accfin.gla.ac.uk](mailto:V.Beattie@accfin.gla.ac.uk)

Acknowledgements

Shamharir Abidin is Senior Lecturer at the Universiti Utara Malaysia and formerly Research Fellow at the University of Stirling, Vivien Beattie is Professor of Accounting at the University of Glasgow and Alan Goodacre is Professor of Accounting and Finance at the University of Stirling. We have benefited from the comments of participants at the BAA Annual Conference at Heriot-Watt University and two anonymous reviewers. The financial support of the Malaysian government (JPA) and the Universiti Utara Malaysia is gratefully acknowledged (for Shamharir Abidin). The usual disclaimer applies.

# Audit Market Structure , Fees and Choice following the Andersen Break-up: Evidence from the UK

## ABSTRACT

This paper presents evidence on audit market concentration and auditor fee levels in the UK market in the crucial period of structural change following the PricewaterhouseCoopers' (PwC) merger and encompassing Andersen's demise (1998-2003). Given the current interest in auditor choice, analysis is also undertaken at the individual audit firm level and by industry sector. There is evidence of significant upward pressure on audit fees since 2001 but only for smaller auditees. Audit fee income for top tier auditors (Big 5/4) did not change significantly while the number of auditees fell significantly, consistent with a move towards larger, less risky, clients. Andersen's demise markedly *reduced* the level of inequality among the top tier firms but PwC retained its position as a 'dominant firm'. On switching to the new auditor, former Andersen clients experienced audit fee rises broadly in line with inflation, with no evidence of fee premia or discounting. They also reported significantly lower NAS fees, consistent with audit firms and auditees responding to public concerns about perceptions of auditor independence. There is no general evidence of knowledge spillover effects or cross-subsidisation of the audit fee by NAS. The combined findings provide no evidence to indicate that recent structural changes have resulted in anticompetitive pricing; the key concern remains the lack of audit firm choice.

*Key words:* Arthur Andersen; audit market; audit fees; concentration; Big 4; industry specialism; competition; low-balling.

# Audit Market Structure , Fees and Choice following the Andersen Break-up: Evidence from the UK

## 1. INTRODUCTION

Rising audit market concentration has attracted the interest of regulators, market participants and academics for many years, especially since the audit firm mega-mergers of the 1980s and 1990s which reduced the global Big 8 to the Big 5. During that period, there was a general concern (based on the predictions of classical micro-economic theory) that excessive concentration would reduce competition, leading to an increase in the price of the services provided by the auditor (Financial Times, 1997). Paradoxically, there was also concern, based on observed market behaviour, regarding excessive competition and low-balling (e.g. CAJEC, 1992). From an industrial economics viewpoint, high seller concentration can both harm consumers and also benefit them through, for example, economies of scale and scope. Although concerns about the so-called ‘mega-mergers’ on competition were raised, in general the regulatory conclusion was that the mergers would be unlikely to substantially lessen competition (Goddard, 1998; Thavapalan *et al.*, 2002).

A further major shock to the system of financial reporting and auditing arose when the US energy giant, Enron, failed in 2001. This event, along with other financial scandals in the US, led to the passage of the Sarbanes-Oxley Act in 2002, which instituted reforms designed to restore confidence in corporate governance. Given the global nature of capital markets and further scandals in Europe (e.g. Parmalat), there have been moves to adopt Sarbanes-Oxley style reforms throughout Europe and elsewhere (Oxley, 2007; Quick *et al.*, 2007). In June 2002, Andersen, one of the top five audit firms in the world, was convicted of obstruction of justice for shredding documents related to Enron.<sup>1</sup> As a result, the firm lost its auditing license in the US.<sup>2</sup> In August 2002, the firm ceased business and, in the UK, was acquired by Deloitte & Touche, reducing the number of big accounting firms from five to four. In the US, the Andersen business was dissolved and former Andersen clients switched to other, mainly Big 4, audit firms. This event sparked further intense debate, which is ongoing, about competition and audit quality in the audit market (e.g., EC, 2002;

OFT, 2002; GAO, 2003; Oxera, 2006; FRC, 2006a, b, c; FRC 2007a, b; FRC 2008; US Treasury, 2007) and provides motivation for the present study.

In the US, the General Accounting Office (GAO) studied the effect of consolidation but found no evidence of impaired competition (GAO, 2003). Prior to Andersen's acquisition, the EC also examined the possible impact of the acquisition, concluding that there was no danger of the creation of a single dominant firm since Andersen and Deloitte were the smallest of the Big 5 firms (EC, 2002). More recently, the US Treasury (2007) announced the formation of an Advisory Committee on the Auditing Profession, which is due to report in mid-2008. One of the principal topics to be considered by the committee is audit market competition and concentration. The specific issues to be considered include, *inter alia*, a comparison of 'the capabilities of the different sizes of auditing firms with the requirements of the large, mid, and small capitalization public companies' (para. 4.1.3.5.2) and how audit market concentration impacts audit quality (para. 4.1.4).

In the UK, a report on competition and choice in the UK audit market was commissioned by the UK Department of Trade and Industry/Financial Reporting Council (Oxera, 2006).<sup>3</sup> This was followed by discussion papers on choice in the UK audit market and promoting audit quality (FRC, 2006a, b; 2007c) and by reports on choice (FRC, 2007a, b). Stakeholders expressed a strong preference for market-led solutions to the problem of restricted choice in the market for audit services to public interest entities in the UK and proposed a package of 15 recommendations designed to lessen concentration over the medium term. These recommendations require action by all market participants including audit firms, investors, companies, regulators and legislators.<sup>4</sup>

Academics have also investigated the impact of Andersen's dissolution on concentration, with Beattie *et al.* (2003) predicting that the acquisition would increase the Big 4's UK listed clientele to 72.8% of all audit clients (96.3% in terms of audit fees). In terms of individual firm market share, it was projected that Deloitte would become the third largest audit firm in the UK, accounting for 19.2 % of the total market (based on audit fees).

However, as the EC and Beattie *et al.* (2003) studies were based on pro-forma figures, there is no published study that documents the *actual* impact of Andersen's dissolution in the UK. Further, since these studies cover only a very short period of time, the extent of change in concentration in the UK listed company audit market in recent years is not yet fully documented. This is especially true for the period following the Price Waterhouse and Coopers & Lybrand merger in 1998. To our knowledge, the only UK study that offers a detailed investigation of audit market concentration among the entire population of listed companies during the 2000s is Beattie *et al.* (2003). Previously, studies undertaken by Briston and Kedsdie (1985), Moizer and Turley (1987, 1989), Beattie and Fearnley (1994), Peel (1997),<sup>5</sup> and Pong (1999) jointly cover the period from 1972 to 1995.<sup>6</sup> The study by Pong and Burnett (2006) examines the years 1997 and 2001. Figures reported in recent studies commissioned or produced by regulators (Oxera, 2006; POB, 2006, 2007; FRC, 2007b) offer limited insights into the structure of the market, due to restricted samples or the use of measures based on only number of audits. Recent academic studies are also based on restricted samples: McMeeking (2007) reports on the FRSE 100 while McMeeking *et al.* (2007) report on 309 listed companies in 2002.

The present study seeks to provide answers to the following specific questions with respect to the UK domestic listed company audit market during the crucial period of structural change 1998-2003:

#### *General issues*

- What was the level of audit market concentration following the PricewaterhouseCoopers' merger and Andersen's demise (i.e., 1998 to 2003) and has it changed significantly?
- Are the larger mid-tier firms in a position to compete in the listed company market?
- Have audit fee rates changed significantly during the period?
- What is the relative importance of joiners, leavers and switchers in explaining the overall change in audit market concentration?

#### *Andersen-related issues*

- How did the Andersen demise affect market concentration?

- Following Andersen's demise, who now dominates the market at industry level?
- Who audits former Andersen clients and did their audit and/or non-audit services (NAS) fees change significantly?

The specific contributions of the paper are fourfold. First, it provides a discussion of both the traditional and contemporary theory of industrial economics and its limitations in relation to making predictions about real markets (and the audit market in particular.) Second, it presents a descriptive analysis of the structure of the entire population of the listed company market (where existing studies cover only restricted samples) and at a detailed level (industry sector and individual firm) for a crucial period of structural change. Third, it offers insights into the complex dynamics underlying observed changes in market structure by undertaking a decomposition analysis. Fourth, it contributes to the growing, and conflicting, Andersen-related literature by (i) analysing the impact of this event in the UK, where no study has yet been published; (ii) documenting the impact on market structure; (iii) analysing the fee impact of the Andersen dissolution, controlling for company size; and (iv) evaluating the possible impact of NAS fee cross-subsidisation on audit fees.

Due to the global nature of many large companies, the capital markets and the audit firm networks, the characteristics of the UK listed company audit market are shared with many other markets worldwide (FRC, 2006a: 8). Thus, the findings and conclusions from the present study have potential relevance in the global setting. Notwithstanding this, however, national markets do have specific characteristics and features. For example, the manner of the Andersen dissolution varied across countries – in the UK most clients transferred to Deloitte & Touche, in Australia most transferred to Ernst and Young and in the US the spread was fairly wide.

The remainder of this paper is organised as follows. The next section provides a brief overview of the economic theory on market structure and behaviour, before considering the unique features of the audit market setting and discussing the factors

that lead to changes in market concentration. This literature section goes on to review prior empirical studies of audit market concentration, the consequences of market concentration and the impact of Andersen's demise on audit pricing. Section 3 outlines the methods used to measure audit market concentration, data sources and data collection methods. Section 4 presents the results and discussion. Finally, Section 5 concludes the study.

## 2. RELATED LITERATURE AND EMPIRICAL STUDIES

### **2.1 *Industrial economics: traditional and contemporary theory***

From the 1940s until the 1970s, the study of industrial organisation has centred on the Structure-Conduct-Performance (SCP) paradigm. This theory posits that there is a direct link from structure, to conduct, to performance. The implication is that the more concentrated an industry, the more market power<sup>7</sup> the organisation exercises and thus the larger the deviation from competitive pricing. This view resulted in aggressive antitrust policy in the US and Europe (Pepall *et al.*, 2008).

Over time, the strict one-way causality assumed by the SCP view was called into question. It was realised that increased concentration, when combined with cost efficiencies, does not necessarily lead to higher prices. In equilibrium, both concentration and performance are endogenously determined by underlying cost and demand parameters (Beattie *et al.*, 2003). Thus, more efficient firms should grow faster than less efficient firms resulting in a more concentrated industry structure. This offers a more benign explanation of the observation that larger market shares go hand in hand with greater profitability.

In the 1970s, researchers at the Chicago School began to consider the importance of strategic interactions among interdependent firms in conditions of imperfect competition and the ability of firms to enter the market. The focus shifted from the study of market structure (S) and performance (P) to the study of conduct (C) (i.e., strategic behaviour). It was gradually realised that the decisions made by firms regarding pricing, nature of product/service, expansion and investment feed back to affect structure. Strategic interaction was modelled using (non-cooperative) game

theory, giving rise to the ‘new industrial organisation’ theory of the 1980s and which continues to the present. The Cournot, Bertrand and Stackelberg models (each with its different assumptions) have become central to the study of oligopoly (Pepall *et al.*, 2008).

Industrial economists have suggested that a tight oligopoly prevails where the market share of the top four firms exceeds 60%, with a loose oligopoly for below 40% market share (Shepherd, 1997). A tight oligopoly has fewer rivals, higher concentration, stable market shares and medium to high barriers to entry, whereas a loose oligopoly has more rivals, lower concentration, unstable market shares and low barriers to entry. Collusion is considered more likely in tight oligopolies.

The PricewaterhouseCoopers merger and the Andersen demise represent *de jure* and *de facto* horizontal mergers, respectively. Such mergers offer an obvious threat to competition. Yet it is difficult to construct an economic model in which there are significant gains to the merged company due to cost efficiencies – this is the ‘merger paradox’. As a consequence of these theoretical ambiguities, competition regulation must also rely on empirical analysis to predict *ex ante* and observe *ex post* the effects of changes in market structure (Pepall *et al.*, 2008, ch. 16).

## ***2.2 The audit market setting***

Yardley *et al.* (1992) and Beattie and Fearnley (1994) review industrial organisational theory and its relation to the audit market. The unique characteristics of the audit market (e.g. statutory requirement for audit and regulated activity) mean that the determinants and consequences of concentration are especially difficult to assess using theoretical analysis and, therefore, must be investigated empirically. The demand for audit is inelastic (as audit is a statutory requirement for listed companies) and there is the possibility of cross-subsidisation of audit fees arising from the provision of non-audit services (NAS). Key general influences on the audit market are economic, political and regulatory in nature: stage in the economic cycle, shocks caused by financial scandals such as Enron and regulatory intervention into the audit market (e.g. corporate governance codes; US Sarbanes-Oxley Act of 2002). The demand from company managers, company board and shareholders for low cost versus high quality audits varies over time. The actual level of concentration and



competition (both price and quality) is the result of complex interactions between these general influences, mediated by specific company and audit firm factors.

### ***2.3 Sources of change in market concentration***

There are three principal sources of change in concentration: change in the set of consumers; change in the set of providers; and realignments (switches). Change in the set of consumers results from new companies entering or exiting the market through initial public offerings, insolvencies and mergers (Beattie *et al.*, 2003). Further, in the case of the market for public listed companies, delisting, re-admission and temporary suspension will also affect the measured concentration level in that particular market segment.

Changes in the set of suppliers can occur as a result of audit firm merger or demise. In the case of the market for audit services, merger is generally stated as the main reason for increased concentration. Mergers and acquisitions have been used as a means for audit firms to expand their business to achieve greater economies of scale and also industry-specific expertise (GAO, 2003). Gramling and Stone (2001) note that audit industry expertise may potentially improve firm efficiency through economies of scale resulting from concentrating resources and technology investment in specific industries. However, industry expertise can also create barriers to entry for competitors, especially for smaller firms. Gramling and Stone (2001) also note that professional standards and emergent risk-based audit technologies demand that audit firms integrate industry expertise into their audit approaches and, as such, auditor specialisation has become both a minimum requirement and a barrier to entry in the audit service market.

Industry specialisation, however, is not the only barrier that smaller firms are facing. According to GAO (2003), high capital requirements, lack of recommendation by capital market participants and high litigation risk and insurance costs are also important, particularly in the case of the audit market for public listed companies.<sup>8,9</sup>

The demise of large audit firms, though very rare, is also popularly thought to increase market concentration. Interestingly, however, neither Comunale and Sexton (2003) nor Duxbury *et al.* (2007) produce this result using Markov chain modelling in

relation to the PricewaterhouseCoopers merger. Further, based on EU data, Ballas (2005) did not find that concentration increased following Andersen's demise.

Voluntary realignments are said to occur where companies initiate the auditor change. In the UK and many other countries, companies are free to change and to select a new auditor, with shareholders' approval. The main reasons for voluntary realignment in the UK during the 1990s have been shown to be high audit fee, dissatisfaction with the auditor's ability to detect problems, changes in company's top management, the need for group auditor rationalisation, the perceived need for a Big 6 auditor, and a company's merger or takeover (Beattie and Fearnley, 1998). If there is an underlying preference for the leading suppliers (currently the Big 4 firms), then these realignments, provided that other factors remain equal, will result in rising concentration (Beattie and Fearnley, 1995; Beattie *et al.*, 2003). Audit firm resignations are uncommon and signal forced change for the client company.<sup>10</sup> However, the political climate may cause some audit firms to reassess the risk profile of their client portfolio and they may not seek reappointment in the case of 'risky' clients.<sup>11</sup>

The informed interpretation of observed changes in market concentration requires an understanding of the nature and relative importance of these various underlying sources of change.

#### ***2.4 Empirical studies of concentration in the UK listed company audit market***

The number of audit firms active in the market has been used as an indicator of market structure. The two concentration measures reported in prior studies are the *k*-firm concentration ratio (CR) and, less commonly, the Hirschman-Herfindahl index (HI). These measures are based on either number of audits or audit fees. Table 1 summarises the findings from 15 prior academic and professional studies on concentration in the UK market, covering the 35 year period 1972-2007. By organising the findings according to time and measure, the trend over time is revealed.

#### **INSERT TABLE 1 ABOUT HERE**

Column 3 of Table 1 show that great care must be taken when comparing the findings from different studies and what is included in the definition of listed companies can

vary greatly. In several studies (Moizer and Turley, 1987, 1989; McMeeking 2007), only the largest companies are included, while in another (Oxera, 2006) there is a bias towards the largest companies. Some studies include only a sample of companies (McMeeking *et al.*, 2007) while others exclude Alternative Investment Market (AIM) companies, which are generally smaller than main market companies. The number of companies on the main market has been declining steadily for 10 years, while the number of AIM companies has been rising at a much faster rate. For this reason, it is increasingly important that studies include this sector of the listed company market to avoid the upward distortion of the large-company focus on concentration measures based only on the main market. Finally, two studies (Pong, 1999; Pong and Burnett, 2006) exclude investment trusts, although this will have no systematic effect provided that they have a similar size distribution to the other companies included in the sample.<sup>12</sup> These choices greatly affect the number of companies included in the ‘UK listed’ sample (see column 4 of Table 1).

Notwithstanding these sampling differences, the general trend over time is one of increasing concentration. In discussing this trend, results from Moizer and Turley (1987, 1989) (rows 1 and 2) and FRC (2007b) (final row) have been ignored due to the restricted samples used. The number of active audit firms has fallen from 362 in 1984 to 85 in 2002 (the figure of 66 for 2001 reported by Pong and Burnett (2006) can perhaps be attributed to their exclusion of some listed companies).<sup>13</sup> The four-firm concentration ratio (CR4), based on number of audits, has risen from 0.38 in 1984 to 0.83 in 2006. Evidence based on the more informative audit fee measure is more limited, but the trend is from 0.77 in 1991 to between 0.93 and 0.97 in 2003/5 (depending on the sample used). Measures of the Herfindahl index based on audit fees indicate a significant increase in concentration (15.9 in 1992 rising to 24.8 in 2001).

Few studies report a comprehensive set of concentration indicators, and the most recent studies to offer a reasonably full picture are Pong (1999) for 1995 and Pong and Burnett (2006) for 1997 and 2001. In particular, the recent official studies (the Oxera Report commissioned by the UK Department of Trade and Industry/Financial Reporting Council and the UK Public Oversight Board (POB) annual accountancy

profession statistics) focus on CR4 for a restricted (and unreported) number of companies.

In a recent published study of the entire population of UK listed companies, Beattie *et al.* (2003) analysed the effect of Andersen's demise on audit market concentration (on a *pro forma* basis) and estimated that the top four firms were likely to increase their market share from about 67% to 73% and from about 90% to 96% on the basis of number of audits and audit fees, respectively. The study identified that the levels of concentration were significantly higher in premier market segments (i.e. FTSE 100 and 250) and in certain industry sectors. Based on actual data drawn from Public Accounting Reports, Feldman (2006) reports that Andersen's exit from the market increased concentration by the top four firms from 85% to 95%.

High and rising levels of audit market concentration have been reported in numerous academic studies undertaken in non-UK countries (e.g., in the US: Wolk *et al.*, 2001 and GAO, 2003; in Australia: Thavapalan *et al.*, 2002; in Germany: Quick and Wolz, 1999; in international markets: Choi and Zeghal, 1999; Narasimhan and Chung, 1998; in the EU: Ballas, 2005). For example, in the US the top four firms audited 63% of total public companies' sales in 1988, rising to 71% by 1997 and 99% by 2002 (GAO, 2003).<sup>14</sup>

## ***2.5 Evidence on the consequences of concentration***

Evidence from audit market concentration studies suggests that increased market concentration does not necessarily decrease competition. For instance, while the merger between Price Waterhouse and Coopers & Lybrand increased the Big 5 market share at the aggregate market level, Thavapalan *et al.* (2002) report that, for a number of industry sectors in Australia, a more equitable spread of audit clients between the Big 5 firms was achieved. The GAO (2003) study also found no empirical evidence to support the contention that competition in the audit service market has been impaired, similar to the earlier studies such as Dopuch and Simunic (1980) and Danos and Eichenseher (1986).

## ***2.6 Consequences of Andersen's demise***

Many studies have investigated the impact of Andersen's demise on issues other than concentration, in particular, auditor selection decisions and audit pricing. In an analytical paper, Schloetzer (2006) analyses a Cournot model of oligopoly to explore the impact of Andersen's break-up. The model predicts that the number of audits completed by the remaining Big 4 audit firms will decline, due to short-run capacity constraints, creating an increase in switching to non-Big 4 firms. He reports evidence consistent with this prediction. Empirical studies of audit pricing following Andersen's demise mostly relate to the US market. Chi (2006), using US data, finds that audit fees across all companies have generally risen following the Andersen event. However, the phenomenon of initial fee discounting is apparent, and among Big 4 clients is statistically greater for former Andersen clients than for non-former Andersen clients. Asthana *et al.* (2004) report that audit fees and the audit fee rate (as a percentage of total assets) of US companies rose markedly in 2002 following the Enron scandal, especially for larger, riskier clients. However, they find that former Andersen clients actually pay lower audit fees in 2002 compared to continuing clients of the Big 4 firms, which is evidence consistent with a competitive market for former Andersen clients. Kealey *et al.* (2007) examine, for a sample of 547 US companies, the impact of audit firm tenure on the level of audit fees paid to Andersen's successor auditors. The observed positive relationship is attributed to the perceived higher level of client risk associated with longer tenure. The change in audit fees arising from the change in auditor is not, however, explored. Kohlbeck *et al.* (2008) report that clients who followed their Andersen audit team paid about the same as in the previous year (i.e., they neither received a 'low-balling' discount nor paid a premium). Those that did not follow the Andersen audit team but moved to another Big 4 auditor paid a premium fee while companies hiring a non-Big 4 audit firm obtained a discounted audit fee, broadly similar in size to the amount of low-balling discount in non-Andersen audit changes. Finally, Vermeer (2008) focuses on the non-profit sector of the US market, providing descriptive data on the type of successor auditor selected and the impact on audit fees.

Outside the US, evidence is limited. Hamilton *et al.* (2008), using Australian data, conclude that overall the market remained competitive following Andersen's break-up. However, they find higher premiums generally for Big 4 audits post-Andersen and the audit fee data reported for former Andersen clients show an above-inflation rise in

aggregate audit fees of 9.8% (derived from Table 1, panel B), though these are not adjusted for the apparent changes (reductions) in auditee size; aggregate NAS for former Andersen clients declined by 1%. The only UK study to date is an unpublished study by Basioudis and Papadimitriou (2007), who find no change in inflation-adjusted audit fees between 2001 and 2002 for former Andersen clients (the unadjusted increase is 10%). Their analysis, however, is based on a restricted sample of only 63 companies. Thus, the available evidence in relation to the pricing effect of Andersen's demise is conflicting.

Researchers have noted that standard, single period cross-sectional audit fee models do not address 'the dynamics of changes in audit fees' and that call for further research on this important issue (Clatworthy and Peel, 2007, p.198). The Andersen failure offers a quasi-experimental setting in which the factors impacting *changes* in audit fees can be observed.<sup>15</sup>

## **2.7 Hypotheses**

Traditional industrial economics theory predicts that mergers will increase market concentration and (in certain circumstances) increase profits. Translating these predictions into the audit setting is, however, problematic. As audit firm costs are unobservable, audit fees (revenues rather than profits) must generally be used to proxy for profits. Further, the market for audit services and the market for NAS are linked due to knowledge spillovers (Stein, 2006), which introduces an additional strategic interaction variable. The scandal associated with Andersen's demise gave rise to a unique merger situation in which the demand for monitoring, which is costly, increased. However, to set against this, the selection of an audit firm requiring a new audit team incurs costly switching costs.

Given the audit firm's demise, companies were forced to change from Andersen acting as both auditor and as the firm providing the consultancy reflected in the NAS reported in the financial statements. They could choose whether to use the newly appointed auditor (resulting in reported NAS) or a different firm to provide NAS (and zero reported NAS). Given the political pressure to avoid potential conflict of interests in joint provision, the reported NAS might be expected to fall to reduce the perceived (or real) threat to auditor independence. Alternatively, knowledge

spillovers and/or the new auditor's desire for increased fees and profit via cross-subsidisation of the audit fee might lead to increased reported NAS.

Based on the above discussion of the theoretical and empirical literature, the following specific hypotheses in relation to the Andersen break-up are tested; following Andersen's demise:

H1: Audit fees generally increased.

H2: Market concentration increased.

H3: Ex-Andersen clients' audit fees increased.

H4: Big 4 firms (but not Deloitte & Touche, the audit firm that took over Andersen in the UK) benefited from audit fee premiums from ex-Andersen clients.

H5a: Reported NAS fees decreased following Andersen's demise (consistent with response to concerns over independence threats).

H5b: Reported NAS fees increased following Andersen's demise (consistent with knowledge spillovers and/or audit fee cross-subsidisation).

### 3. METHODS

The audit market examined in the present study concerns the auditors of all domestic UK companies listed on both the main and AIM markets of the London Stock Exchange (LSE) for the period 1998 through 2003. Information about companies, their auditors and industry classification was extracted from the Waterlow Stock Exchange Yearbook (SEYB).<sup>16</sup> Accounting data (sales, total assets and audit fees) were mainly sourced from Datastream with recourse to FAME and annual reports to fill in missing data. These data requirements reduced the sample size and led to the exclusion of investment trust companies, in particular. For companies identified as having changed auditors, audit firm details were cross-checked against annual reports or, in the few situations where these were not available, against data in FAME.

Changes in the audit market can be caused by the entry and exit of companies to and from the stock exchange. Information about newly listed companies, re-admission and new issues was obtained from the 'Primary market fact sheet' published by the

LSE. Information about delisted companies was sourced from Hemscott, Datastream and Citytext. Audit firm mergers in the 1998 to 2003 period were identified from Boys (2003) and individual audit firms' web pages.

Three measures of market concentration have been applied previously in audit market studies. The two widely used measures are the  $k$ -firm concentration ratio (CR) and the Hirschman-Herfindahl index (HI). The third measure, the Gini Coefficient, though used in many economic related studies to measure inequality in wealth is relatively new to audit market studies. It was used by Quick and Wolz (1999) in their investigation of the German audit market. A description of each measure follows.

The  $k$ -firm concentration ratio measures the proportion of total output in an industry produced by a given number of the largest firms in the industry. It is calculated as follows:

$$CR_k = \frac{\sum_{i=1}^k x_i}{\sum_{i=1}^n x_i}$$

where:

- $n$  = the total number of audit firms in the market,
- $k$  = the number of largest firms considered, and
- $x_i$  = the market share of each audit firm (typically based on the number of audits, audit fees, or proxies for client size such as total assets or sales).

The second measure, the Hirschman-Herfindahl (HI) index, is a market-wide concentration measure that is sensitive to the number of active firms and to the variance in activity levels across firms. It has been used in the US to aid in the interpretation of concentration data (GAO, 2003) and is calculated as follows:

$$HI = \frac{\sum_{i=1}^n x_i^2}{\left( \sum_{i=1}^n x_i \right)^2} \times 100$$



The upper and lower bounds of the HI index are 100 and 0. If there is only one firm active in the market the index equals 100, while the index approaches 0 when there are numerous firms of equal size. The HI has two advantages over concentration ratios. First, it is based on all market participants rather than just the  $k$  largest firms (Pong, 1999). Second, it gives a better indication of the relative market control of the largest firms (as a result of the squared measure). For example, a 4-firm concentration ratio of 80% could be made up of one firm with 60% and three sharing the 20%, or perhaps four firms having 20%. The former would result in a higher HI measure, reflecting the concentration in the largest firm (Wootton *et al.*, 1994).

The Gini coefficient is closely linked to the Lorenz curve and measures something subtly different to CR and HI, namely the inequality *between* market participants. This can be of specific benefit when comparing the market shares within the Big5/4 group, for example. Its value lies between 0 and 100, where 0 means perfect equality and 100 means perfect inequality (i.e., one firm has all the income with everyone else earning nothing). The higher the coefficient, the greater the inequality of income in the market. An advantage of the Gini coefficient is that it is not easily affected or disturbed by changes in the size of a population. If the data is ordered by increasing size of market share, it is calculated as follows:<sup>17</sup>

$$Gini = \left( \frac{2}{n^2 \bar{x}} \right) \sum_{i=1}^n \left[ \left( i - \frac{n+1}{2} \right) x_i \right] \times 100$$

where:

$i$  = market share rank (from smallest to largest), and

$\bar{x} = \frac{1}{n} \sum_{i=1}^n x_i$  (i.e., the mean market share).

All three measures provide an indication of market concentration for the aggregate audit market. To obtain more information about the dominance of individual participating firms, the calculation of individual audit firms' market share is required.

Four different measures of market share have been used to date. The number of audits is perhaps the most commonly used measure; it is intuitive, facilitates reconciliation with changes in the population of consumers and auditor switches and its calculation requires knowledge only of the identity of the auditor. However, the

existence of an audit is a poor measure of activity level and so, in settings where audit fees are disclosed, audit fees are used as the measure of choice. Concentration measures based on number of audits, while highly correlated with measures based on audit fees, are known to be systematically lower due to the ‘size effect’, whereby large companies tend to employ large audit firms. In settings where audit fees are not disclosed, inferior measures of total assets or total sales are used to proxy activity level; in the present study, the preferred measure of audit fees is used.

## 4. RESULTS AND DISCUSSION

### *4.1 Descriptive statistics*

Table 2 provides descriptive statistics for the six-year period. The number of companies decreased from 1,607 in 1998 to 1,386 in 2003, with the number of audit firms decreasing from 85 to 72. To put this trend into context, in 1968 there were 1,109 audit firms active in the public listed market (Briston and Kedslie, 1985). Further, the 72 ‘active’ audit firms represent a tiny proportion of the nearly 20,000 accounting firms in the UK (International Financial Services, 2003). The small number of ‘active’ audit firms suggests significant barriers to entry in the public listed company audit market. It may be noted that a similar number of ‘active’ firms (85) audit the much larger US market (7,006 public companies) (Who Audits America, 2003).

### **INSERT TABLE 2 ABOUT HERE**

Auditee company size, with respect to total assets, ranged from just £3,000 to a high of £455 billion. In term of sales, some companies in each year reported £0 sales and the highest sales reported was £61 billion in 2002. The mean values for both total assets and sales increased by considerably more than inflation over the period (see RPI change in Table 2, row 4). As mean values can be heavily influenced by outliers, the median is also shown. Over the six year period, the median values of total assets and sales fell by 10% and 20%, respectively. The rise in mean and fall in median reflect an increase in the numbers of both large and very small companies since 1998. A comparison of the size distributions (based on total assets) in 1998 and 2003 shows that the proportion of companies with assets above £500 million increased from 16% to 20%, and the proportion below £30 million from 37% to 42%.

Audit fees ranged between £1,000 and £18 million. Over the six year period, mean (median) audit fees rose by 35% (10%) compared with general price inflation of 11%. The increase in the mean ahead of inflation may reflect high increases in audit fees for large companies and/or the higher proportion of large companies in the population already identified. Therefore, to explore whether the increase in audit fees merely reflects an increase in client size, the rate of audit fees per unit of size is reported. The last two panels in Table 2 show that, in terms of *aggregate* audit fee charged related to total assets, the rate fell from 1998 to a low in 2001 then picked up in 2002; the trend based on sales was broadly similar. The mean value of *individual* fee rates suggests that there was a sizeable increase in audit fee rate (scaled by total assets) in 2001 and 2002.<sup>18</sup> The corresponding increase in median audit fee rate is much more moderate. By contrast, both mean and median audit fee rates based on sales started to increase earlier (in 2000) and showed a decrease by 2003.

One plausible explanation for the mid-period increase is the regulatory and public response to Andersen's misconduct. Following the downfall of Andersen and the subsequent public concern about audit quality, companies had a smaller number of large auditors to choose from, so the remaining audit firms had greater market power. The early increase in audit fee rates in 2001 can perhaps be linked to the auditing industry atmosphere during the period. As widely reported in the press, the Enron scandal began in 2000, with Enron filing for the largest Chapter 11 bankruptcy protection in U.S. history in 2001.

To further investigate how Andersen's demise and related events affected the cost of audits, audit fee rates (per £000 total assets) for each size decile of companies are analysed for each of the years 2001, 2002 and 2003 (see Table 3 and Figure 1). The graph in Figure 1 clearly shows that, as expected due to fixed costs and audit scale economies, the audit fee rate decreases as company size increases. Comparison over time reveals that the mean (and median) audit fee rate increased between 2001 and 2003 for each decile of company size. However, as shown in Table 3, the smallest companies have experienced a major (and statistically significant) increase of 155% (53%) in mean (median) audit fee rates, in contrast to an increase of 13% (19%) for the largest companies.

Thus, there is evidence of significant upward pressure on audit fees since 2001 for smaller audit clients. However, attribution of causation is not straightforward. The price rises might reflect a general economic improvement which enabled auditors to catch up on price increases delayed as a result of the 2001 UK downturn. Alternatively, they might reflect a genuine ‘Andersen effect’ (consistent with Hypothesis 1): either auditors have undertaken additional audit work and passed on the increased costs to clients or, perhaps, they have taken advantage of their increased market power following the reduction to four top tier auditors.

**INSERT TABLE 3 and FIGURE 1 ABOUT HERE**

#### ***4.2 Aggregate audit market concentration***

Table 4 reports the level of auditor concentration from 1998 to 2003 using two different measures of market share<sup>19</sup> and three different measures of concentration (CR – rows 1-4; HI – row 5; and Gini – rows 6-7). Based on both market share measures, the CR4 concentration ratio increased over the six-year period, particularly in 2002 and 2003 with the transfer of a majority of Andersen clients to other Big 4 auditors (see later). Thus, there is some evidence to support Hypothesis 2. However, the aggregate market share of the large top tier auditors (shown as CR (Big 5/4) in the table) generally increased by much less. A notable contradiction here is the CR (Big 5/4) market share based on number of audits, which *fell* every year in the period (a pattern not shared with the Australian market (Hamilton *et al.*, 2008)); over the six year period the decline from 76% to 68% was statistically significant at the 1% level. In other words, audit fee income for top tier auditors has risen while the number of auditees has fallen. This is consistent with the argument and evidence that the Big 5/4 auditors have shifted their client portfolio towards larger, less risky, clients (Jones and Raghunandan, 1998; Rama and Read, 2006).<sup>20</sup> CR6 and CR20 have been relatively stable over the six-year period across both measures.

**INSERT TABLE 4 ABOUT HERE**

Focusing on the concentration statistics based on the preferred audit fee proxy (panel B), the level of audit market concentration in the UK during the 6 year period has remained very high. In 1998 the top tier firms (then Big 5) audited 95% of the market and by 2003 this had grown to 96% (now Big 4). The increases in CR4 and CR6 over

the period are statistically significant at the 1% level (2-tail). Looking back to 1991,<sup>21</sup> the top tier (then Big 6) had a markedly lower market share of 89% (Pong, 1999).

The domination of the top tier firms clearly exceeds the economists' 60% tight oligopoly threshold (Shepherd, 1997). The UK domestic listed audit market was a tight oligopoly by any market share proxy during the period of the present study (and back to 1991 at least). The lowest CR (Big5/4) was 68% in 2003 (number of audits) but was consistently above 94% based on audit fees. Such high concentration levels facilitate the possibility of successful collusion, overt or tacit, between the top firms.

In contrast to the  $k$ -firm concentration ratio, the more comprehensive HI and Gini coefficients for the whole market suggest a slight net decline in audit market concentration over the six year period. This contrasts with evidence from the US which finds concentration to have increased (Feldman, 2006). These contrasting outcomes can perhaps be attributed to the substantially smaller market share of Andersen in the UK compared to the US; based on audit fees for 2001, Andersen's market share was 8.8% in the UK (Pong and Burnett, 2006) and 15.9% in the US (Feldman, 2006). In the UK, the HI measure fell between 1998 and 2001 to 25.0 after which it began to rise slowly to 27.0 in 2003. The 2001 value is almost identical to the 24.8 reported by Pong and Burnett (2006) but the 25.8 for 2002 is slightly higher than the 23.0 which McMeeking *et al.* (2007) report, based on their smaller sample. The Gini coefficient for the whole market (penultimate row in each panel) declined slightly to 2000 and then remained broadly stable.

In the US, the Department of Justice and the Federal Trade Commission classify the HI into three regions with a value below 10 characterising an unconcentrated market, a value between 10 to 18 characterising a moderately concentrated market and a value above 18 characterising a highly concentrated market (GAO, 2003). The present study reports an HI (based on number of audits) ranging between 12 and 14 (signalling moderate concentration). However, HI based on audit fees ranged between 25 and 28, signalling a highly concentrated audit market with potential for significant market power.

The Gini (whole market) coefficient remained very high throughout the entire period suggesting considerable inequality of market share across auditor participants.

However, while the Andersen demise had little impact on the overall picture, it has markedly reduced the level of inequality between the top tier firms. Looking back to 1991 and 1995, the Gini coefficients for top tier (then Big 6) market share based on audit fees were 29 and 30, respectively.<sup>22</sup> The final row in panel B reports the Gini (Big 5/4) coefficient for the study period. In 1998, the coefficient had risen to 48 (for the Big 5) but the impact of the redistribution of former Andersen clients reduced this to 30 (for the Big 4) by 2003.<sup>23</sup> Thus, the equality of audit market share for the four top tier firms has now returned to the level it was at prior to the Price Waterhouse/Coopers & Lybrand merger. This is explored further in the next section.

#### ***4.3 Individual firm market share at market level***

Given the current interest in auditor choice and the viability of a challenge to the Big 4 by mid-tier firms (FRC, 2007b), analysis is also undertaken at the individual audit firm level (for the top tier and six leading mid tier firms). Several observations can be made from the detailed analysis of market shares by individual firm shown in Table 5. Based on audit fee ranking, PwC was the market leader with total market share of about 40%, a level that industrial organisation theorists cite as the cut-off level to identify the existence of a ‘dominant firm’ (Beattie *et al.*, 2003). It is interesting to note that the PwC market share was always markedly higher than that of the number two firm throughout the period. KPMG, the nearest rival, held only 23-26% of the market share. According to Shepherd (1997), a dominant firm usually has two effects on prices similar to those of pure monopoly. First, they raise the level of their prices, often (though not always) gaining excess profits. Second, they engage in price discrimination.

#### **INSERT TABLE 5 ABOUT HERE**

Over the full 1998 to 2003 period, the market share of PwC and KPMG declined slightly (both number of audits and audit fees) while that of Ernst & Young declined based on number of audits but increased a little based on audit fees. Following its acquisition of Andersen, Deloitte gained considerably both in terms of audit fees and number of audits during 2002 and 2003. Interestingly, these gains continued an upward trend that started much earlier than Andersen’s demise and saw its market share almost double (number of audits) with a larger increase based on audit fees.

Overall, the Big 4 are now more closely aligned in terms of audit market share as indicated by the Gini coefficients discussed in the previous section.

By contrast, the audit fee market share gap between the Big 4 and other smaller firms has become wider over the 6 year period. This is clearly demonstrated by comparing the market shares of Ernst & Young, the smallest of the Big 4, and of the non-Big 4 auditors. Based on audit fees, E&Y had 13% market share in 2003, which was more than three times as large as the *entire* non-Big 4 market share (4%). BDO Stoy Hayward, the closest rival to the Big 4, held just above 1% market share, indicating its very weak position relative to the Big 4. It is worth noting, however, that the mid-tier consolidation merger between Grant Thornton and Robson Rhodes in the summer of 2007 serves to narrow the gap slightly.

#### ***4.4 Changes in Big 5/4 market dominance***

To examine the underlying factors that have contributed to changes in concentration, a decomposition analysis of the aggregate Big 5/4 concentration ratio changes over the 1998 to 2003 period is presented in Table 6. The impact of four distinct consumer-based reasons for change is calculated: leavers; net joiners; non-par auditor switches; and (in the case of audit fees measure only) audit fee changes. Panels A and B focus on number of audits and audit fees, respectively. Leaver companies include those that were acquired, failed, went private or left the market for any other reason. The analysis of joiners recognises that some joiners may have left the market by 2003. The analysis of switchers focuses on non-par auditor changes (i.e., those involving a change in audit firm tier). In total, there were 464 switches, representing 5.8% per annum using the number of audits in 1998 (1607) as the baseline; of these, almost half (202) were non-par changes.

Panel A shows an overall reduction in Big 5/4 market share of 7.4% (from 75.9% to 68.5%) based on *number of audits*. The Big 5/4 audited about 75% of the leaver companies that were listed in 1998, closely in line with their overall market share in 1998. However, they had a much smaller market share (51%) of companies joining the market since 1998, which accounts for the overall reduction in the Big 5/4 market share based on number of audits. The impact of non-par switches between Big 5/4 and

other auditing firms was broadly neutral, with the Big 5/4 showing a small net loss of 4 audits.

### **INSERT TABLE 6 ABOUT HERE**

The analysis of market share based on *audit fees* (Panel B) shows differences in the scale and overall impact of factors. The Big 5/4 market share shows an overall *increase* between 1998 and 2003 of 1.0% (from 94.9% to 95.9%). The Big 5/4's lower market share of leavers (91%) implies a higher market share of continuing companies, up 1.4% from 94.9% to 96.3%. This represents the largest cause of the overall change in concentration. The change in continuing clients' audit fees had a small negative impact on concentration (decline of 0.5%). While the Big 5/4 audited just over half of joiners, these tended to be the larger joining companies so the audit fees represented 88% of the total for joiners. Of these joiners, 62 had left the market by 2003 and the Big 5/4 share of their audit fees was 76%. Together, this left the Big 5/4 with 91% market share of joiner audit fees. However, as this was below their overall 1998 market share, the impact was to reduce slightly their market share, contributing a reduction of 0.5% in concentration. While there was a very small net loss of audits by Big 5/4 to others, the Big 5/4 actually achieved a net gain in audit fees from voluntary auditor change of £2.8 million; this led to a small rise (0.6%) in audit fee market share.

In summary, since 1998 the Big 5/4 have a smaller number of audits (279 less), primarily because they audit a smaller number of new entrants to the market. However, they have managed to increase audit fees (by £66 million) and their share of audit fees, as a result of two main factors. First, the Big 5/4 have retained a larger share of audit fees for companies that have remained in the market. This is consistent with the retention of Big 5/4 auditors by companies that have grown either organically or by acquisition. Second, they tended to gain larger companies as clients as a result of switches. This may reflect a Big 5/4 strategy of avoiding audits which they perceive to be high-risk, as evidenced in the US (Jones and Raghunandan, 1998; Rama and Read, 2006).

#### ***4.5 Industry concentration***



Beattie *et al.* (2003) showed that in 2002 the Big 5 audited the entire FTSE 100 companies and almost 98% of the FTSE 250 companies.<sup>24</sup> Apart from auditor reputation, it has been argued that an auditor's technical capability in specific industry sectors is the main factor that causes large companies to choose a top tier auditor (Neal and Riley, 2004; Ferguson *et al.*, 2006; Knechel *et al.*, 2007). This industry-specific technical capability can be achieved by specialisation, at both the national and city level (Ferguson *et al.*, 2006; Basioudis and Francis, 2007).<sup>25</sup> Table 7 presents auditor market share (based on audit fees) in industry sectors for 2003. This shows that one of the Big 4 firms was the market leader in every one of the 34 industry sectors. PwC was the leader in 18 industries, KPMG was the leader in eight, while Deloitte and Ernst & Young were both leaders in four industries.

#### **INSERT TABLE 7 ABOUT HERE**

There is no consensus on the level of market share that indicates industry specialism. Prior studies have used various levels of market share including 10% and 20% (Craswell *et al.*, 1995), 30% (Knechel *et al.*, 2007) and more recently 50% (Beattie *et al.*, 2003). Table 7 identifies the market leader in each sector (underlined) as well as the auditors in the 20 sectors where a market share of at least 50% is held (**in bold**). From the table, the leading position of PwC among the Big 4 is clear (see summary at bottom of table). PwC audits the entire tobacco sector (three companies) and has more than 90% market share in the oil and gas (31 companies) and steel and other metals (four companies) sectors. Overall, PwC is the market leader in 18 sectors and has at least 50% market share in 11 sectors. By comparison KPMG, Deloitte and Ernst & Young have at least 50% market share in only six, one and two sectors, respectively. In the UK in 2003, the average market share of the industry leader (across 29 non-financial sectors) was 58%, with the second ranking firm having 22%.<sup>26</sup>

Focussing on the relatively large sectors (by number of companies), 17 contain 30 or more companies (Craswell *et al.*, 1995). PwC was market leader in 10 of these large sectors. Just five sectors had a market leader auditor with at least 50% market share (PwC for 4 sectors and Ernst & Young for 1). Based on market capitalisation, there were 13 sectors larger than £50 billion. However, only PwC and KPMG had more than 50% market share in those sectors (PwC for 3 sectors and KPMG for 3). PwC

was the market leader in six sectors, while KPMG, Deloitte and Ernst & Young were the leaders in four, two and one sector, respectively.

In aggregate, the Big 4 clearly dominated all sectors, with their lowest market share being 87% (in Housing Goods & Textiles, a sector with a large number of small companies). The Big 4 has complete dominance in four sectors: Forestry & Paper, Tobacco, Banks and Life Assurance. The dominance of one or two Big 4 auditors in a significant number of sectors is likely to be of concern to companies desiring an industry-specialist auditor. It implies that their choice is severely restricted, especially if they wish to avoid the auditor of a competitor. Further, while most of the sectors dominated by a single Big 4 auditor (>50% market share) are relatively small in terms of the number of companies (26% of the 1,386 companies are in such sectors), they represent a significant part of the market with 52% of market capitalisation.

In eleven sectors, however, one or more mid-tier firms did claim a significant presence ( $\geq 2\%$  audit fees) and in 9 sectors a mid-tier firm's market share exceeded that of one of the B4 firms. There were only two mid-tier firm sector market shares in excess of 5% - BDO Stoy Hayward held 7.8% in General Retailers and Grant Thornton held 7.3% in Electronic & Electrical Equipment. But, in two further sectors, 'other' smaller non-Big 4 auditors (i.e., firms not identified separately in the table) in aggregate held significant market shares – 6.9% in Housing Goods and Textiles and 5.9% in Diversified Industrials. These findings offer some hope that, if the recommendations of the FRC (2007b) audit choice study are put in place, mid-tier firms may, in the medium-term, represent viable alternatives to a B4 auditor.

#### ***4.6 Analysis of auditor choice and fees paid by former Andersen clients***

In 2001, Andersen had 97 clients who changed auditor the following year, while in 2002 Andersen had 36 clients remaining (those with fiscal year ended before August). As the focus in this section is a pre/post comparison, eight companies that delisted in 2002 or 2003 were removed, leaving 125 former Andersen clients for analysis.

#### **INSERT TABLE 8 ABOUT HERE**

Table 8 provides a summary for former Andersen clients of the successor auditor (panel A) and, for each successor, aggregate audit fees, median audit fee rates pre and

post change, aggregate NAS fees and aggregate total fees (panels B to E, respectively). Different rows of the table distinguish different key groupings of audit firms – in particular, the B4 excluding Deloitte, in addition to the B4 and non-B4. Panel A shows that Deloitte, Andersen's UK acquirer, captured 93 (74%) former Andersen clients; 21 (17%) companies moved to another Big 4 auditor and 11 (9%) chose non-Big 4 firms. The largest non-Big 4 beneficiaries were BDO Stoy Hayward and Robson Rhodes, both second tier firms with international operations. The percentage of companies that switched to another Big 4 was slightly higher in the UK than in the US. The GAO (2003) study reported that 86% of former Andersen clients chose another Big 4 auditor (including Deloitte) and 14% switched to a non-Big 4 auditor. In the US, the switch to other Big 4 firms was more uniform than in the UK: Ernst & Young (26%); KPMG (25%); Deloitte (20%); and PwC (15%). Of 1,085 former Andersen US clients, the study reported that 717 (66%) companies switched to non-Deloitte Big 4 (compared to only 17% in the UK).

Andersen clients' global preference towards another Big 4 firm is not unexpected given the international reputation and capability of the Big 4. The figures in Table 8 give an indication of the redistribution of clients that might occur if there were to be a further reduction from a B4 to a B3 (a scenario considered by FRC, 2007b). In addition, the importance to such companies of restoring investor and other stakeholder confidence was high. For example, Chaney and Philipich (2002) provide evidence that many former Andersen clients had experienced negative market reaction when Andersen admitted to shredding Enron's documents.

Panels B reports aggregate audit fees. For new Big 4 auditors, aggregate audit fees rose by 4.0% in contrast to a decline of -12.0% for new non-Big 4 auditors; the median change in audit fees for new Big 4 auditors was 0.0% compared with -10.0% for non-Big 4. Across all clients, the change in aggregate audit fees was 3.8%, broadly in line with inflation, with a median audit fee change of 0.0%. Thus, in rejection of Hypothesis 3 and in contrast with prior US and Australian research, there is no evidence of general above-inflation audit fee rises in the UK following Andersen's demise.

Similarly, there is no evidence of general fee discounting on initial audit engagement for former Andersen clients, in contrast with the evidence reported by Chi (2006) for

the US. Ernst & Young gained the largest clients (based on total assets) and also achieved above-inflation audit fee increases of 11.7%, in aggregate. Not surprisingly, the non-Big 4 gains were typically smaller companies with smaller audit fees. The median decline in audit fee of -10.0% in respect of non-Big 4 successor auditors can be attributed to the loss of the Big 4 audit premium and/or more significant fee discounting on initial audit engagements by small auditors (as found in the US by Ghosh and Lustgarten, 2006 and Kohlbeck *et al.*, 2008).

The overall 5.0% rise in audit fees for moves to Deloitte Touche, the acquirer of the Andersen UK business, is slightly above the rate of inflation. This is broadly consistent with the 'no change' result for clients who followed the Andersen audit team in the US (Kohlbeck *et al.*, 2008). However, in contrast with their results, the aggregate audit fee increase for moves to other Big 4 auditors of 1.6% (median change of 0.0%) provides no evidence of a fee premium in the UK, which does not support Hypothesis 4.

The audit fee rates (audit fees per £000 total assets) reported in Panel C seek to take client size changes over the year of change into account (albeit imperfectly). Medians are reported to reduce the impact of outliers, though the small sample size for non-Big 4 auditees and for individual Big 4 successors (except DT) still affects the stability of the median. However, the median percentage change in audit fee rate was 3.0% (1.7%) for Big 4 (non-Big 4) and 2.4% overall; all are positive but again broadly in line with inflation, confirming that the audit fee results are not driven by changes in client size.

Overall, the lack of clear evidence of real (i.e. above inflation) audit fee rises for Andersen clients is perhaps surprising. These clients had a smaller pool of (large) audit firms from which to choose (especially when specialisation and refusal to appoint competitors' auditors are considered), which creates a demand pressure. The clients were also in a relatively weak bargaining position given their need to rebuild confidence. It suggests that either there was still sufficient competition to negate oligopolistic excesses, or the Big 4 did not seek to extract excess profits, politically aware that their actions would be closely monitored.

Panel D reports the level of NAS provided by Andersen and by the successor auditor. It is interesting to consider whether the incentives to reduce NAS to counter a perceived lack of auditor independence are greater than the benefits of knowledge spillovers and/or of the cross-subsidisation of audit fees. Overall, it is clear that reported NAS fees (i.e. those provided by the auditor) fell significantly in aggregate following Andersen's demise: for Big 4 successors by -20%, for non-Big 4 by -47% and overall by -20%; the median change in NAS was -13.2% overall and -17.1% for the major acquirer DT. Similarly, total fees (audit plus NAS) paid by auditees declined, by -12.2% overall (Panel E) with a median change of -3.9%. Thus, there is no general evidence of knowledge spillover effects or cross-subsidisation of the audit fee by NAS (Hypothesis 5b). The evidence is consistent with the notion that audit firms and their clients responded to publicly-expressed concerns that NAS provision has the potential to affect external perceptions of auditor independence (Hypothesis 5a).

However, the detail shows that two audit firms (PwC and KPMG) did generate higher NAS fees than Andersen from the clients it took over. PwC generated an additional £0.7m NAS, also leading to an increase in total fees of £0.5m; the equivalent increases for KPMG were £0.5m (NAS) and £0.3m (total fees). The median changes in NAS for the individual four B4 auditors were: KPMG +8.4%; PwC 0.0%; DT -17.1%; and EY -52.6%. While this suggests that both KPMG and PwC may have gained, possibly from cross-subsidisation of audit fees by NAS income, this needs cautious interpretation given the very small sample sizes. Further, given the major market share of PwC (Pong and Burnett, 2006), it is perhaps likely that PwC was already providing a higher level of consultancy services to Andersen-audited companies than other audit firms. Any consultancy provided by the successor auditor prior to its commencement as auditor would need to be reported in the financial statements as NAS, potentially with greater impact for PwC than other firms.

## 5. SUMMARY AND CONCLUSIONS

This paper presents evidence on audit market concentration and audit fee rates in the UK domestic listed company market during a crucial period of structural market

change (i.e., following the PricewaterhouseCoopers' merger and encompassing Andersen's demise, 1998-2003). Concentration is measured using two different size measures (number of audits and audit fees) and three measures of concentration (the  $k$ -firm concentration ratio, the Hirschman-Herfindahl index and the Gini coefficient), offering a detailed and consistent insight into trends over the six year period. Analysis is also undertaken at the individual audit firm level (for both the top tier and leading mid-tier firms) and by 34 industry sectors.

Concentration is shown to have been consistently high throughout the period, characteristic of a 'tight oligopoly'. Based on audit fees, the market share of the top tier (Big 5 in 1998; Big 4 in 2003) was 95% in 1998 and 96% in 2003. However, there is clear evidence that concentration has, in a number of respects, shown a declining trend over the six-year period. The top tier concentration ratio based on number of audits fell from 76% to 68% (significant at 1%). Moreover, the more comprehensive measures (Herfindahl index and Gini coefficient) showed slight decreases for the market as a whole and marked decreases for the top tier (in terms of both number of audits and audit fees). It can be concluded that Andersen's demise has reduced the level of inequality between the top tier firms.

Decomposition analysis indicates that the main factor underlying the drop in Big 5/4 concentration *based on number of audits* was the relatively small number of audits gained from joiners, a market segment dominated by the mid-tier firms. If the mid-tier firms can retain these clients as they grow either organically or by acquisition, then market concentration will decrease. The main factor underlying the slight increase in Big 5/4 concentration *based on audit fees* was the retention of Big 5/4 auditors by companies that have grown either organically or by acquisition. A secondary factor was that they tended to gain larger companies as clients as a result of switches. This may reflect investor and client preferences for a top tier auditor as they grow, or a Big 5/4 strategy of avoiding the smaller (and therefore higher-risk) companies (Jones and Raghunandan, 1998; Rama and Read, 2006). The rate of auditor change was reasonably high (5.8% p.a.) over the period, higher than reported in prior UK studies (4.1% p.a. in Beattie and Fearnley, 1994; 4.5% p.a. in Pong, 1999). This could be argued to indicate signs of increased competition brought about, in particular, by audit committees exercising their responsibilities in relation to

auditor selection and appointment more actively during this period due to regulatory pronouncements in relation to corporate governance (e.g., Hampel Report, 1998; Smith Committee, 2003). However, our evidence suggests that switching was not a major cause of change in concentration.

Extant evidence from Australia and the UK indicates that it is industry specialism, at both national and city level, and not just brand name that contributes to fee premia and auditor selection choices (Ferguson *et al.*, 2003; 2006; McMeeking *et al.*, 2006; Basioudis and Francis, 2007). This study shows that mid tier firms could compete effectively in certain industries where they already have a significant presence. In eleven sectors, one or more mid-tier firms audited at least 2% audit fees, and in 9 sectors a mid-tier firm's market share exceeded that of one of the B4 firms. An effective challenge from the mid-tier firms would be assisted by the implementation of the recommendations of the FRC (2007b) audit choice study. It could be further assisted by the mid tier firms adopting a strategy of investing and marketing themselves on the basis of industry specialism.

Andersen's demise served to reduce the level of inequality between the top tier firms, with Deloitte capturing approximately 70% of Andersen clients and total audit fees. Thus, consistent with the findings of Comunale and Sexton (2003) in the US context and Ballas (2005) in the EU context (but contrary to popular belief) the exit of a top tier firm does not necessarily result in increased market concentration. However, PwC retained its position as a 'dominant firm', with 40% market share (based on audit fees) in 2003. PwC was also market leader in 18 out of 34 industry sectors in 2003. Given these high levels of market concentration and the limited number of industry specialist firms, listed companies continue to face a restricted choice of audit firm in the short-term. The small percentage of market share held by the non-Big 4 indicates the presence of significant barriers to entry faced by smaller firms.<sup>27</sup>

There is evidence that the audit fee rate of listed UK companies increased markedly following Andersen's demise. The mean (and median) audit fee rate (based on total assets) increased between 2001 and 2003 for each company size decile. It was, however, the smallest companies that experienced a major (and statistically significant) increase of 155% (53%) in mean (median) audit fee rates, in contrast to an increase of 13% (19%) for the largest companies. Given the lack of evidence

indicating anti-competitive behaviour by the top tier firms, despite high concentration levels, this finding supports the assertion that the Enron scandal lifted the intense pressure on audit fees and caused audit fees to increase substantially. There was a desire by companies and audit firms to instil confidence about audit quality in the financial market participants after this was damaged by Andersen's misconduct (the 'Andersen effect'). Thus, companies wanted more effort from their auditor, placing upward pressure on audit fees. Of course alternative interpretations are also consistent with the evidence – the audit fee rises may simply reflect changes in the general economic climate.

In relation to former Andersen clients, there was no significant above-inflation change in audit fees paid by them to their new auditors (the aggregate increase was 3.8%, with a median increase of 0%). The lack of evidence to indicate that recent structural changes have resulted in anticompetitive pricing is consistent with Duxbury *et al.*'s (2007) modelling of the UK setting. It contrasts, however, with the evidence in Australia, where former Andersen clients paid higher audit fees (Hamilton *et al.*, 2008) and in the US, where initial fee discounts were reported (Chi, 2006). For non-Big 4 successor auditors in the UK, we find a median decline in audit fee of -10.0%. This can be attributed to the loss of the Big 4 audit premium and/or more significant fee discounting on initial audit engagements by small auditors (as found in the US by Ghosh and Lustgarten, 2006). Moves to Big 4 auditors other than Deloitte Touche (who acquired most of the Andersen UK business) were not accompanied by an audit fee premium yet there was also no evidence of general fee discounting, both in contrast with the US (Chi, 2006). Overall, the UK audit market response to Andersen's decline seems to have been relatively benign leading to a restrained 'business as usual' effect.

The lower level of observed NAS in the year of change to a new auditor following Andersen's demise provides little evidence of either knowledge spillover effects or cross-subsidisation of audit fees. Rather, it is consistent with a client (and audit firm) response to concerns over the potential impact of NAS on perceptions of auditor independence.



The combined findings provide no evidence to indicate that recent structural changes have resulted in anticompetitive pricing in the UK listed company audit market. The key concern remains the lack of audit firm choice.

## NOTES

<sup>1</sup> On 31 May 2005, the US Supreme Court announced its unanimous decision to reverse this conviction.

<sup>2</sup> The firm also audited Worldcom, another company involved in accounting scandal. This added another blow to Andersen and contributed to its dissolution.

<sup>3</sup> The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance.

<sup>4</sup> They are intended to: "increase the feasibility of investment in the supply of audit services to public interest entities by existing non-Big 4 firms or new firms; reduce the perceived risks to directors of selecting a non-Big 4 firm; improve the accountability of boards for their auditor selection decisions; improve choice from within the Big 4; reduce the risk of firms leaving the market without good reason; and reduce uncertainty and disruption costs in the event of a firm leaving the market."

<sup>5</sup> Peel (1997) includes quoted and unquoted public limited companies and private companies.

<sup>6</sup> Another study investigates the frequency of individual changes during the 1990s but not the overall level of concentration (Moizer and Porter, 2004).

<sup>7</sup> Market power refers to conditions where the providers of a service can consistently charge prices above those that would be established by a competitive market.

<sup>8</sup> Barriers to entry restrict new entrants to the market at the top end in particular.

<sup>9</sup> The OFT (2004, paras 4.16-4.18) reported that the B4 firms have been subject to some of the highest cost increases but that professional indemnity insurance remains available to all.

<sup>10</sup> Moizer and Porter (2004, pp. 63-65) report that, out of 609 auditor changes, there were 294 (48%) auditor resignations, as evidenced by letters filed with the company registrar. However, the audit partners interviewed by them suggested that 'genuine mid-term resignations are very rare'. They explained that most resignations resulted from the practice of putting audits out to tender; i.e. the existing auditor 'resigns' when a new auditor is appointed. Such evidence casts serious doubt on the validity of categorising auditor changes based on resignation letters.

<sup>11</sup> The available evidence on this, which relates to the US market, is mixed - Johnstone and Bedard (2004) and Schloetzer (2006) find evidence that Big N firms retain clients with lower audit risk, while Landsman *et al.* (2008) attribute the adjustments in audit client portfolios to Andersen-induced capacity constraints rather than client risk aversion.

<sup>12</sup> Investment trusts are generally excluded because a full set of financial data is not available. C4 (based on audit fees) for investment trusts in 2002 was 0.90 (calculated from Table 3, p.259 of Beattie *et al.* (2003)) in comparison with 0.89 across all sectors.

<sup>13</sup> The figure of 85 firms in 1982 is based on the FT 500 only; the figure of 84 in 2003 is a pro forma figure. While Pong and Burnett (2006) include AIM companies in their sample (personal communication, 7 January 2008), their sample size is somewhat smaller than ours (see Table 2).

<sup>14</sup> Until recently, audit fee data was not publicly available in the US.

<sup>15</sup> The passage of the Sarbanes-Oxley Act would not have affected audit fees until 2004, the year that Section 404 became effective (Schloetzer, 2006, p11), and so is not a confounding effect in the analysis of audit fee changes in 2002-03.

<sup>16</sup> Previously known as the Macmillan Stock Exchange Yearbook.

---

<sup>17</sup> This sample Gini coefficient needs to be multiplied by  $n/(n-1)$  to obtain unbiased estimators of population coefficients.

<sup>18</sup> To avoid gross distortion caused by extreme values, the 1% trimmed mean is reported.

<sup>19</sup> Concentration based on two more market share measures, auditee total assets and auditee sales, were also calculated. As the overall patterns of concentration are similar to those based on audit fees, they are not reported here in the interests of brevity.

<sup>20</sup> The willingness of firms to drop risky clients is illustrated by Deloitte's resignation from Easier in 2004 (Accountancy Age, 2005a)

<sup>21</sup> Pong (1999) is the first study to report audit market concentration for the full UK market based on audit fees. Although Moizer and Turley (1987) used audit fees, their sample was limited to FTSE500 companies.

<sup>22</sup> These were calculated using data taken from Pong (1999, Table 3, p. 461).

<sup>23</sup> The temporary rise in the Gini coefficient to 46 for 2002 reflects the fact that a relatively small number of clients continued to be audited by Andersen, giving the firm a small market share and leading to a wider inequality of market shares between the 5 top tier auditors. A broadly similar pattern of reduction in top tier inequality by 2003 is indicated in Panel A of Table 4, where the Gini coefficient is based on number of audits. However, the smaller Gini coefficients (e.g. 15 for 2003) imply a much lower level of inequality between the Big 4; i.e. the number of companies that each firm audits is quite similar.

<sup>24</sup> The FTSE 100 comprises the 100 largest companies (by market capitalisation) and the FTSE 250 comprises next largest 250 companies. Together they comprise the largest 350 UK listed companies and account for 74% of listed companies' total audit fees (Beattie *et al.*, 2003).

<sup>25</sup> It has been shown that industry specialist auditors reduce earnings management attempts, indicating that they provide higher quality audits (e.g. Kwon *et al.*, 2007).

<sup>26</sup> An interesting comparison is with the US market pre Andersen's demise. Based on 2000-01 audit fee data for 63 non-financial industries, Francis *et al.* (2005: 119) report that industry leaders had, on average, 50% of industry fees, with the second ranking firm having 22%.

<sup>27</sup> Interestingly, however, in 2005 BDO Stoy Hayward became the first non-top tier firm to audit a FTSE 100 company upon the initial public offering of Partygaming (Accountancy Age, 2005b).

## REFERENCES

- Accountancy Age (2005a) 'Another auditor quits Easier', 11 August.
- Accountancy Age (2005b) 'BDO steps up to FTSE100', 30<sup>th</sup> June.
- Asthana, S., Balsam, S. and Kim, S. (2004) 'The effect of Enron, Andersen, and Sarbanes-Oxley on the market for audit services', available at SSRN: <http://ssrn.com/abstract=560963>.
- Ballas, A. (2005) 'Market shares and concentration in the EU auditing industry', Paper presented at the European Accounting Association annual conference, Gothenberg.
- Basioudis, I.G. and Francis, J.R. (2007) 'Big 4 audit fee premiums for national and office-level industry leadership in the United Kingdom', *Auditing: A Journal of Practice & Theory*, 26(2), pp.143-166.
- Basioudis, I.G. and Papadimitriou, M. (2007) 'An analysis of UK Andersen clients pre- and post Andersen demise: Where have they gone and did they pay more?', Aston Business School.
- Beattie, V. and Fearnley, S. (1994) 'The changing structure of the market for audit services in the UK - a descriptive study', *British Accounting Review*, 26(4), pp. 301-322.
- Beattie, V. and Fearnley, S. (1995) 'The importance of audit firm characteristics and the drivers of auditor change in UK listed companies', *Accounting and Business Research*, 25(1), pp. 227-239.
- Beattie, V. and Fearnley, S. (1998) 'Audit market competition: auditor changes and the impact of tendering', *British Accounting Review*, 30(3), pp. 261-289.
- Beattie, V., Goodacre, A. and Fearnley, S. (2003) 'And then there were four: a study of UK audit market concentration - causes, consequences and the scope for market adjustment', *Journal of Financial Regulation and Compliance*, 11(3), pp. 250-265.
- Boys, P. (2003) 'What's in a name: firms' simplified family trees on the web', Retrieved August 4<sup>th</sup>, 2003, from <http://www.icaew.co.uk>.
- Briston, R. and Kedslie, M. (1985) 'Must smaller firms continue to lose out?', *Accountancy*, (March), pp. 163-164.
- CAJEC (1992) *Predatory Pricing*, Discussion Paper, Chartered Accountants Joint Ethics Committee.
- Chaney, P.K. and Philipich, K.L. (2002) 'Shredded reputation: the cost of audit failure', *Journal of Accounting Research*, 40(4), pp. 1221-1245.

- Chi, W. (2006) 'The effect of the Enron-Andersen affair on audit pricing', *The ICAI Journal of Audit Practice*, 3(2), pp. 35-59.
- Choi, M.S. and Zeghal, D. (1999) 'The effect of accounting firm mergers on international markets for accounting services', *Journal of International Accounting, Auditing and Taxation*, 8(1), pp. 1-22.
- Clatworthy, M.A. and Peel, M.J. (2007) 'The effect of corporate status on external audit fees: evidence from the UK', *Journal of Business Finance & Accounting*, 34(1&2), pp. 169-201.
- Comunale, C.L. and Sexton, T.R. (2003) Current accounting investigations: Effect on big 5 market shares. *Managerial Auditing Journal*. 18(6/7), pp. 569-576.
- Craswell, A.T., Francis, J.R. and Taylor, S.L. (1995) 'Auditor brand name reputations and industry specialization', *Journal of Accounting and Economics*, 20(3), pp. 297-322.
- Danos, P. and Eichenseher, J.W. (1986) 'Long-term trends toward seller concentration in the US audit market', *Accounting Review*, 61(4), pp. 633-650.
- Dopuch, N. and Simunic, D.A. (1980) 'The nature of competition in the auditing profession: a descriptive and normative view', in Buckley, J.W. and Weston, J.G. (Eds.), *Regulation and the Accounting Profession*, (Belmont, CA: Lifetime Learning Publication).
- Duxbury, D., Moizer, P. and Wan-Mohamed, W.A. (2007) 'Effects of the PricewaterhouseCoopers merger on the UK audit services market', *Managerial Auditing Journal*, 22(2), pp. 121-138.
- EC (2002) *Case No COMP/M.2810 Deloitte & Touche/Andersen (UK)*, European Commission.
- Feldman, E.R. (2006) 'A basic quantification of the competitive implications of the demise of Arthur Andersen', *Review of Industrial Organization*, 29(3), pp. 193-212.
- Ferguson, A., Francis, J.R. and Stokes, D.J. (2003) 'The effects of firm-wide and office-level industry expertise on audit pricing', *The Accounting Review*, 78(2), pp. 429-448.
- Ferguson, A.C., Francis, J.R. and Stokes, D.J. (2006) 'What matters in audit pricing: Industry specialization or overall market leadership?', *Accounting and Finance*, 46(1), pp. 97-106.
- Financial Times (1997) 'Consolidating accounts', 19<sup>th</sup> September, p.13.

- Francis, J.R., Richelt, K. and Wang, D. (2005) 'The pricing of national and city-specific reputations for industry expertise in the U.S. audit market', *The Accounting Review*, 80(1), pp. 113-136.
- FRC (2006a) *Choice in the UK Audit Market*, Discussion paper. (London: Financial Reporting Council).
- FRC (2006b) *Promoting Audit Quality*, Discussion paper. (London: Financial Reporting Council).
- FRC (2006c) *Choice in the UK Audit Market*, Briefing Paper for Second Stakeholder Meeting. (London: Financial Reporting Council).
- FRC (2007a) *Choice in the UK Audit Market*, Interim Report of the Market Participants Group. (London: Financial Reporting Council).
- FRC (2007b) *Choice in the UK Audit Market*, Final Report of the Market Participants Group. (London: Financial Reporting Council).
- FRC (2007c) *Promoting Audit Quality*, Report. (London: Financial Reporting Council).
- FRC (2008) *Choice in the UK Audit Market: Progress Report and Further Consultation*. (London: Financial Reporting Council).
- GAO (2003) *Public Accounting Firms: Mandated Study on Consolidation and Competition*, (General Accounting Office) retrieved July 3<sup>rd</sup>, 2003, from <http://www.gao.gov>.
- Ghosh, A. and Lustgarten, S. (2006) 'Pricing of initial engagements by large and small audit firms', *Contemporary Accounting Research*, 23(2), pp. 333-368.
- Goddard, G.K. (1998) 'ACCC Assessment of the Coopers and Lybrand and Price Waterhouse merger: analysis of competition in the provision of professional services by Big Six accounting firms', *Australian Business Law Review*, 26, pp. 402-17.
- Gramling, A.A. and Stone, D.N. (2001) 'Audit firm industry expertise: a review and synthesis of the archival literature', *Journal of Accounting Literature*, 20, pp. 1-29.
- Hamilton, J., Li, Y. and Stokes, D. (2008) 'Is the audit services market competitive following Arthur Andersen's collapse?', *Accounting and Finance*, 48(2), pp. 233-258.
- Hampel Report (1998) *Committee on Corporate Governance – Final Report*, (London: Gee and Co).
- International Financial Services (2003) *Accounting Services: City Business Series*, retrieved September 1<sup>st</sup>, 2004, from <http://www.ifsl.org.uk>.

- Johnstone, K. and Bedard, J. (2004) 'Audit firm portfolio management decisions', *Journal of Accounting Research*, 42, pp. 659-690.
- Jones, F.L. and Raghunandan, K. (1998) 'Client risk and recent changes in the market for audit services', *Journal of Accounting and Public Policy*, 17(2), pp. 169-181.
- Kealey, B.T., Lee, H.Y. and Stein M.T. (2007) 'The association between audit-firm tenure and audit fees paid to successor auditors: Evidence from Arthur Andersen', *Auditing: A Journal of Practice & Theory*, 26(2), pp. 95-116.
- Knechel, W.R., Naiker, V. and Pacheco, G. (2007) 'Does auditor industry specialization matter? Evidence from market reaction to auditor switches', *Auditing: A Journal of Practice & Theory*, 26(1), pp. 19-45.
- Kohlbeck, M., Mayhew, B., Murphy, P. and Wilkins, M. (2008), 'Competition for Andersen's clients', Working paper, available at [ssrn.com/abstract=900130](http://ssrn.com/abstract=900130).
- Kwon, S.Y., Lim, C.Y. and Tan, P.M-S. (2007) 'Legal systems and earnings quality: The role of auditor industry specialization', *Auditing: A Journal of Practice & Theory*, 26(2), pp. 25-55.
- Landsman, W.R., Nelson, K.K. and Rountree, B. (2008) 'Auditor switches in the pre- and post-Enron eras: risk or realignment?', *Accounting Review*, forthcoming.
- McMeeking, K.P. (2007) 'Competition in the UK accounting services market', *Managerial Auditing Journal*, 22(2), pp.197-217.
- McMeeking, K.P., Peasnell, K.V. and Pope, P.F. (2006) 'The determinants of the UK big firm premium', *Accounting and Business Research*, 36(3), pp. 207-231.
- McMeeking, K.P., Peasnell, K.V. and Pope, P.F. (2007) 'The effect of large audit firm mergers on audit pricing in the UK', *Accounting and Business Research*, 37(4), pp.301-319.
- Moizer, P. and Porter, B. (2004) *Auditor Resignations and Dismissals in the UK*, (London: Centre for Business Performance, Institute of Chartered Accountants in England and Wales).
- Moizer, P. and Turley, S. (1987) 'Surrogates for audit fees in concentration studies - a research note', *Auditing: A Journal of Practice and Theory*, 7(1), pp. 118-123.
- Moizer, P. and Turley, S. (1989) 'Changes in the UK market for audit services: 1972-1982', *Journal of Business Finance & Accounting*, 16(1), pp. 41-53.
- Narasimhan, R. and Chung, S. (1998) 'Auditor concentration of listed public companies on international stock exchanges', *Journal of International Financial Management and Accounting*, 9(3), pp. 201-215.

- Neal, T.L. and Riley, R.R. (2004) 'Auditor Industry Specialist Research Design', *Auditing: A Journal of Practice & Theory*, 23(2), pp. 169-177.
- OFT (2002) *Competition in Audit and Accountancy Services - A Statement by the OFT*, November. (London: Office of Fair Trading).
- OFT (2004) *An Assessment of the Implications for Competition of a Cap on Auditors' Liability*, November. (London: Office of Fair Trading).
- Oxera (2006) *Competition and Choice in the UK Audit Market*. (The Oxera Report) (London: Department of Trade and Industry/Financial Reporting Council).
- Oxley, M.G. (2007) 'The Sarbanes-Oxley Act of 2002 – Restoring investor confidence', *Current Issues in Auditing*, 1(1), pp. C1-C2.
- Peel, M. (1997) 'UK auditor concentration: a descriptive note', *Accounting and Business Research*, 27(4), pp. 311-22.
- Pepall, L., Richards, D. and Norman, G. (2008) *Industrial Organization: Contemporary Theory and Empirical Applications* Malden, MA: Blackwell Publishing).
- POB (2006) *Key Facts and Trends in the Accountancy Profession*. (London: Professional Oversight Board).
- POB (2007) *Key Facts and Trends in the Accountancy Profession*. (London: Professional Oversight Board).
- Pong, C. (1999) 'Auditor concentration: a replication and extension for the UK audit market 1991-1995', *Journal of Business Finance & Accounting*, 26(3/4), pp. 451-475.
- Pong, C.K.M. and Burnett, S. (2006) 'The implications of merger for market share, audit pricing and non-audit fee income', *Managerial Auditing Journal*, 21(1), pp. 7-22.
- Quick, R. and Wolz, M. (1999) 'Concentration on the German audit market - an empirical analysis of the concentration on the German market for stock corporation audits', *International Journal of Auditing*, 3(3), pp. 175-189.
- Quick, R., Turley, S. and Willekens, M. (2007) *Auditing, Trust and Governance: Developing Regulation in Europe*. (Oxford: Routledge).
- Rama, D.V. and Read, W.J. (2006) 'Resignations by the Big 4 and the market for audit services', *Accounting Horizons*, 20(2), pp. 97-109.
- Schloetzer, J.D. (2006) 'Arthur Andersen, SOX Section 404 and auditor turnover: theory and evidence', working paper, available at [ssrn.com/abstract=970586](http://ssrn.com/abstract=970586).



- Shepherd, W.G. (1997) *The Economics of Industrial Organization*, 4th edition, (New Jersey: Prentice-Hall International).
- Smith Committee (2003) *Audit Committee Combined Code Guidance*. (London: Financial Reporting Council).
- Stein, M.T. (2006) ‘Discussion of “An economic analysis of audit and nonaudit services: The trade-off between competition crossovers and knowledge spillovers”’, *Contemporary Accounting Research*, 23(2), pp.555-564.
- Thavapalan, S., Moroney, R. and Simnett, R. (2002) ‘The effect of the PricewaterhouseCoopers merger on auditor concentration in Australia: a note’, *Accounting and Finance*, 42(2), pp. 153-167.
- US Treasury (2007) *Working Discussion Outline*, (Advisory Committee on the Auditing Profession) available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/outline-10-15-07.pdf> (retrieved 19th December 2007).
- Vermeer, T.E. (2008) ‘Market for former Andersen clients: evidence from government and non-profit sectors’, *Journal of Accounting and Public Policy*, 27(5), pp. 394-408.
- Yardley, J.A., Kauffman, N.L., Cairney, T.D. and Albrecht, W.D. (1992) ‘Supplier behaviour in the US audit market’, *Journal of Accounting Literature*, 11, pp. 151-184.
- Who Audits America (2003) *Who audits America*, 47th edition, (Menlo Park, California: Data Financial Press).
- Wolk, C.M., Michelson, S.E. and Wootton, C.W. (2001) ‘Auditor concentration and market shares in the US: 1988-1999 a descriptive note’, *British Accounting Review*, 33(2), pp. 157-174.
- Wootton, C.W., Tonge, S.D. and Wolk, C.M. (1994) ‘Pre and post Big 8 mergers: comparison of auditor concentration’, *Accounting Horizons*, 8(3), pp. 58-74.
- Wu, M.G.H. (2006) ‘An economic analysis of audit and nonaudit services: The trade-off between competition crossovers and knowledge spillovers’, *Contemporary Accounting Research*, 23(2), pp.527-554.

**Table 1: Concentration in the UK listed company audit market: evidence from prior studies 1972-2007**

Time	Paper	Sample	Sample size	No. of active audit firms	No. of audits					Audit fees				
					CR4	CR6	CR8	CR20	H Index	CR4	CR6	CR8	CR20	H Index
1972	Moizer & Turley (1987,1989)	FT 500	498	144	0.37	0.44	0.50		4.6	0.47	0.60	0.66		7.1
1982	Moizer & Turley (1987,1989)	FT 500	499	85	0.42	0.54	0.63		6.6	0.54	0.69	0.79		9.4
1984	Briston & Kedslie (1985)	Domestic		362	0.38	0.49	0.57	0.76						
1987	Beattie & Fearnley (1994)	Domestic inc USM <sup>1</sup>	1642	216	0.43	0.55	0.64	0.83						
1988	Beattie & Fearnley (1994)	Domestic inc USM <sup>1</sup>	1769	191	0.45	0.57	0.67	0.86						
1989	Beattie & Fearnley (1994)	Domestic inc USM <sup>1</sup>	1871	174	0.45	0.57	0.68	0.88						
1990	Beattie & Fearnley (1994)	Domestic inc USM <sup>1</sup>	1978	167	0.59	0.72	0.79	0.90						
1991	Beattie & Fearnley (1994)	Domestic inc USM <sup>1</sup>	2070	166	0.59	0.72	0.79	0.90						
1991	Pong (1999)	Inc USM; exc inv trusts	1211		0.57	0.70	0.79			0.77	0.89	0.93		15.9
1992	Pong (1999)	Inc USM; exc inv trusts	1222		0.58	0.71	0.79			0.79	0.90	0.94		
1993	Pong (1999)	Inc USM; exc inv trusts	1237		0.59	0.73	0.80			0.80	0.91	0.94		
1994	Pong (1999)	Inc USM; exc inv trusts	1320		0.61	0.74	0.82			0.79	0.92	0.95		
1994/5	Narasimhan & Chung (1998)	Domestic	1400		0.61	0.75	0.82		16.7 <sup>2</sup>					
1994/5	Peel (1997)	Inc USM and AIM <sup>3</sup>	1865			0.78								
1995	Pong (1999)	Inc USM; exc inv trusts	1401	106	0.60	0.75	0.82			0.79	0.92	0.94		17.0
1997	Pong & Burnett (2006)	Inc AIM; exc inv trusts	1280	86	0.61	0.77			11.4	0.81	0.94			17.6
2001	Pong & Burnett (2006)	Inc AIM; exc inv trusts	1094	66	0.64				13.4	0.86				24.8
2002	McMeeking <i>et al.</i> (2007)	Sample of non-financial	309		0.80				22.0	0.88				23.0
2002	Beattie <i>et al.</i> (2003)	Inc AIM <sup>3</sup>	2180	85	0.67		0.86			0.89				
2003 <sup>4</sup>	Beattie <i>et al.</i> (2003)	Inc AIM <sup>3</sup>	2180	84	0.73		0.89			0.96				
2004	Oxera (2006)	Selected listed exc AIM <sup>5</sup>	676							0.97				
2005	Oxera (2006)	Selected listed exc AIM <sup>6</sup>	865							0.93				
2005	McMeeking (2007)	FTSE 100 <sup>7</sup>	100		1.00									
2005	POB (2006)	Main market exc AIM	~1000 <sup>8</sup>		0.83									
2006	POB (2006)	Main market exc AIM	~1000 <sup>8</sup>		0.83									
2007	POB (2007)	Main market exc AIM	~1000 <sup>8</sup>		0.82									
2007	FRC (2007b)	FTSE 350	350	7	0.97									

- Notes:
1. USM was the Unlisted Securities Market; sample includes Irish companies.
  2. Index calculated for top 8 firms only.
  3. AIM is the Alternative Investment Market, secondary to the main market.
  4. Pro forma following Andersen's collapse, assuming all Andersen clients gained by Deloitte & Touche (the acquirer of Andersen UK).
  5. Includes only companies with audit fees available from FAME database (approx. 69% of population).
  6. Includes only those companies where auditor identity available from Datastream (approx. 89% of population, biased towards larger companies).
  7. A second sample that also included 80 additional listed companies was also considered.
  8. Approximate sample size inferred from Table 23 (pp. 58-61) of POB (2007).

**Table 2: Descriptive statistics: UK domestic listed companies**

	1998	1999	2000	2001	2002	2003	1998 - 2003 change (%)
Sample Size	1,607	1,498	1,479	1,539	1,497	1,386	
Number of Auditors	85	80	74	78	77	72	
Retail Price Index (RPI)	163.4	165.6	171.1	174.4	176.2	181.3	11.0
<i>RPI Change (%)</i>	-	+1.4	+3.3	+1.9	+1.0	+2.9	
<b>Total Assets (£m)</b>							
Mean	1,519	1,884	2,150	2,230	2,383	2,673	76.0
<i>Mean Change (%)</i>	-	+24	+14	+4	+7	+12	
Median	53	58	57	50	45	48	-9.9
<i>Median Change (%)</i>	-	+9	-2	-12	-11	+7	
Minimum	0.106	0.045	0.174	0.006	0.003	0.006	
Maximum	219,500	254,800	316,200	358,534	403,100	455,275	
<b>Sales (£m)</b>							
Mean	526	580	634	636	657	731	39.0
<i>Mean Change (%)</i>	-	+10	+9	0	+3	+11	
Median	52	53	45	40	35	41	-20.4
<i>Median Change (%)</i>	-	+1	-14	-12	-11	+17	
Minimum <sup>1</sup>	0	0	0	0	0	0	
Maximum	33,340	37,017	51,503	49,254	60,826	49,039	
<b>Audit fees (£000)</b>							
Mean	252	268	268	270	301	339	34.5
<i>Mean Change (%)</i>	-	+6	0	+1	+11	+13	
Median	68	70	69	68	71	75	10.3
<i>Median Change (%)</i>	-	+3	-1	-1	+4	+6	
Minimum	2	3	2	2	3	1	
Maximum	14,431	14,172	16,926	13,892	15,901	17,920	
<b>Audit fees per £000 total assets</b>							
Aggregate <sup>2</sup>	0.166	0.142	0.125	0.121	0.126	0.127	-23.5
Mean <sup>3</sup>	2.05	2.19	1.98	2.53	3.35	3.66	78.5
<i>Mean Change (%)</i>	-	+7	-9	+28	+32	+9	
Median	1.38	1.36	1.25	1.38	1.60	1.63	18.4
<i>Median Change (%)</i>	-	-2	-8	+10	+16	+2	
Minimum	0.011	0.006	0.007	0.008	0.009	0.008	
Maximum	191	222	46	1,333	1,333	829	
<b>Audit fees per £000 sales<sup>4</sup></b>							
Aggregate <sup>2</sup>	0.48	0.461	0.423	0.424	0.458	0.464	-3.3
Mean <sup>3</sup>	4.62	5.06	11.45	16.74	20.48	8.29	79.4
<i>Mean Change (%)</i>	-	+10	+126	+46	+22	-60	
Median	1.33	1.32	1.54	1.77	1.89	1.80	35.3
<i>Median Change (%)</i>	-	0	+17	+14	+7	-5	
Minimum	0.026	0.034	0.039	0.037	0.029	0.032	
Maximum	2,571	2,333	12,000	10,000	7,000	10,000	

Notes: 1. Several companies did not report any sales during the year.

2. Aggregate = (sum of all company audit fees)/(sum of all company total assets or sales).

3. To avoid gross distortion by outliers, the 1% trimmed mean (0.5% from top and bottom) is reported.

4. Companies without sales were excluded from analysis.

**Table 3: Effect of client size on audit fee rate****Panel A: Mean audit fee per £000 total assets**

	<i>Small</i>		<b>Size decile</b>							<i>Large</i>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
2001	10.74	4.40	3.05	2.02	1.87	1.34	1.21	0.81	0.50	0.29
2002	17.07	4.77	3.48	2.23	2.22	1.67	1.22	0.89	0.54	0.31
2003	27.42	5.25	3.51	2.54	2.26	1.67	1.28	0.97	0.57	0.33
2003 vs. 2001 t-stat <sup>1</sup>	2.91***	1.98**	1.45	2.96***	1.92	2.28**	0.64	1.85	1.43	1.37

**Panel A: Median audit fee per £000 total assets**

	<i>Small</i>		<b>Size decile</b>							<i>Large</i>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
2001	6.70	3.51	2.54	1.70	1.50	1.12	0.97	0.62	0.40	0.21
2002	8.46	4.19	2.79	1.78	1.78	1.23	1.01	0.76	0.40	0.22
2003	10.31	4.52	2.84	2.14	1.86	1.33	1.10	0.80	0.47	0.25
2003 vs. 2001 z-stat <sup>1,2</sup>	5.59***	2.38**	1.69	2.82***	1.57	2.25**	0.73	1.71	1.84	1.87

<sup>1</sup> \*\* =  $p < 5\%$ , \*\*\* =  $p < 1\%$  (2-tail)<sup>2</sup> Wilcoxon Mann-Whitney test.

**Table 4: Auditor concentration in the UK domestic listed company market: 1998 to 2003**

<b>Panel A: Based on number of audits</b>							<b>1998 vs. 2003</b>
	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>z- stat <sup>2</sup></b>
CR4	67.02	65.69	63.62	61.99	66.40	68.47	0.85
CR (Big 5/4) <sup>1</sup>	75.86	75.30	72.95	70.63	68.80	68.47	-4.51***
CR6	80.46	80.57	78.43	76.93	78.96	80.66	0.14
CR20	94.65	95.79	95.54	95.39	95.12	94.81	0.20
HI	14.36	13.81	12.78	12.13	12.63	13.32	
Gini (whole market)	87.88	87.50	86.50	86.48	86.12	86.19	
Gini (Big 5/4) <sup>1</sup>	29.89	19.25	24.00	23.69	32.00	14.72	

<b>Panel B: Based on audit fees</b>							<b>1998 vs. 2003</b>
	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>z- stat <sup>2</sup></b>
CR4	87.85	87.95	86.44	87.86	93.53	95.94	7.95***
CR (Big 5/4) <sup>1</sup>	94.94	95.29	94.68	94.66	95.06	95.94	1.30
CR6	96.00	96.56	96.15	96.16	96.41	97.85	2.89***
CR20	99.20	99.31	99.30	99.36	99.44	99.57	1.29
HI	27.80	26.64	25.28	25.02	25.80	27.04	
Gini (whole market)	96.09	95.88	95.33	95.65	95.95	96.06	
Gini (Big 5/4) <sup>1</sup>	47.88	44.17	41.09	42.13	46.00	29.73	

*Notes:*

1. Big 5 up to 2002. Most Andersen clients (97 companies) changed auditor in 2002, however, there were 36 companies' still audited by Andersen in 2002. These companies were treated as Andersen clients until publication of the next annual report in 2003.

2. Standard test of difference between proportions; \*\*\* =  $p < 1\%$  (2-tail). Equivalent tests for HI and Gini unavailable.

**Table 5: Auditor market share (rank) by individual firm**

	Market share (rank) based on													
	No. of audits							Audit fees						
	1998 %	1999 %	2000 %	2001 %	2002 %	2003 %		1998 %	1999 %	2000 %	2001 %	2002 %	2003 %	
PwC	26.32	(1) 24.97	(1) 22.45	(1) 21.44	(1) 20.57	(1) 20.85	(1)	43.43	(1) 42.71	(1) 40.57	(1) 39.23	(1) 37.72	(1) 40.01	(1)
KPMG	19.91	(2) 19.49	(2) 19.41	(2) 18.45	(2) 18.50	(2) 18.47	(2)	25.62	(2) 23.16	(2) 23.81	(2) 25.18	(2) 26.12	(2) 23.57	(2)
Deloitte & Touche	9.52	(4) 10.61	(3) 10.62	(4) 11.50	(3) 16.50	(3) 18.33	(3)	7.09	(5) 9.72	(4) 11.39	(3) 13.18	(3) 18.62	(3) 19.53	(3)
Ernst & Young	11.26	(3) 10.61	(3) 11.16	(3) 10.59	(4) 10.82	(4) 10.82	(4)	11.44	(3) 12.36	(3) 10.67	(4) 10.28	(4) 11.06	(4) 12.83	(4)
Andersen	8.84	(5) 9.61	(5) 9.33	(5) 8.64	(5) 2.40	(8) -	-	7.37	(4) 7.34	(5) 8.24	(5) 6.80	(5) 1.53	(5) -	-
<b>Total Big 5/4</b>	<b>75.86</b>	<b>75.30</b>	<b>72.95</b>	<b>70.63</b>	<b>68.80</b>	<b>68.47</b>		<b>94.94</b>	<b>95.29</b>	<b>94.68</b>	<b>94.66</b>	<b>95.06</b>	<b>95.94</b>	
BDO Stoy Hayward	4.60	(6) 5.27	(6) 5.34	(7) 6.24	(7) 6.08	(6) 5.84	(6)	1.06	(6) 1.28	(6) 1.47	(6) 1.50	(6) 1.35	(6) 1.02	(5)
Grant Thornton	4.48	(7) 4.61	(7) 5.48	(6) 6.30	(6) 6.48	(5) 6.35	(5)	0.88	(7) 0.88	(7) 1.13	(7) 1.22	(7) 1.12	(7) 0.90	(6)
Baker Tilly	1.00	(11) 1.13	(11) 1.69	(10) 1.56	(11) 3.61	(7) 4.18	(7)	0.18	(12) 0.18	(11) 0.23	(11) 0.20	(12) 0.49	(8) 0.53	(7)
Robson Rhodes	1.31	(9) 1.54	(9) 1.49	(11) 1.62	(10) 1.74	(9) 1.80	(9)	0.36	(10) 0.33	(8) 0.34	(8) 0.32	(9) 0.32	(9) 0.26	(8)
Pannell Kerr Forster	1.49	(8) 1.60	(8) 1.83	(8) 1.88	(8) 1.67	(10) 2.02	(8)	0.36	(9) 0.28	(9) 0.32	(9) 0.33	(8) 0.25	(11) 0.21	(9)
Moore Stephens	0.75	(13) 0.80	(12) 0.74	(13) 0.78	(13) 1.07	(11) 1.08	(10)	0.37	(8) 0.26	(10) 0.27	(10) 0.23	(11) 0.29	(10) 0.19	(10)
Others	10.52	9.75	10.48	10.98	10.55	10.25		1.84	1.51	1.56	1.54	1.12	0.96	
<b>Total Non-Big 5/4</b>	<b>24.14</b>	<b>24.70</b>	<b>27.05</b>	<b>29.37</b>	<b>31.20</b>	<b>31.53</b>		<b>5.06</b>	<b>4.71</b>	<b>5.32</b>	<b>5.34</b>	<b>4.94</b>	<b>4.06</b>	
<b>Total</b>	100	100	100	100	100	100		100	100	100	100	100	100	
Total audit fees (£m)								405	401	397	415	450	470	
Number of companies	1,607	1,498	1,479	1,539	1,497	1,386								

*Note: Ordered on 2003 audit fee market share.*

**Table 6: Analysis of Big 5/4 concentration movement: 1998-2003**

**Panel A: Based on number of audits**

	All UK	Non- Big 5/4 Number of audits (% of all UK)	Big 5/4 Number of audits (% of all UK)
Number of audits in 1998	1607	388 (24.1)	1219 (75.9)
<i>Leavers listed in 1998</i>	<u>(643)</u>	<u>(160)</u> (24.9)	<u>(483)</u> (75.1)
<i>Continuing companies</i>	964	228 (23.7)	736 (76.3)
<i>Companies joining LSE 1999-2003</i>	541	262 (48.4)	279 (51.6)
<i>Leavers who joined after 1998</i>	<u>(119)</u>	<u>(57)</u> (47.9)	<u>(62)</u> (52.1)
Net joiners	<u>422</u>	<u>205</u> (48.6)	<u>217</u> (51.4)
	1386	433 (31.2)	953 (68.8)
Non-par switches:			
<i>Auditor change <u>to</u> Big 5/4 1999-2003</i>		(99)	99
<i>Auditor change <u>from</u> Big 5/4 1999-2003</i>		<u>103</u>	<u>(103)</u>
		4	(4)
Number of audits in 2003	1386	437 (31.5)	949 (68.5)

**Panel B: Based on audit fees (£000)**

	All UK	Non- Big 5/4 Total audit fee (% of all UK)	Big 5/4 Total audit fee (% of all UK)
Audit fees in 1998	405,211	20,514 (5.1)	384,697 (94.9)
<i>Leavers listed in 1998</i>	<u>(116,897)</u>	<u>(10,154)</u> (8.7)	<u>(106,743)</u> (91.3)
<i>Continuing companies' audit fees at 1998</i>	288,314	10,360 (3.6)	277,654 (96.3)
<i>Continuing companies' audit fee changes</i>	<u>134,821</u>	<u>7,158</u> (5.3)	<u>127,663</u> (94.7)
<i>Continuing companies' audit fees at 2003</i>	423,135	17,518 (4.1)	405,317 (95.8)
<i>Companies joining LSE 1999-2003</i>	55,030	6,319 (11.5)	48,711 (88.5)
<i>Leavers who joined after 1998</i>	<u>(8,015)</u>	<u>(1,957)</u> (24.4)	<u>(6,058)</u> (75.6)
Net joiners	<u>47,015</u>	<u>4,362</u> (9.3)	<u>42,653</u> (90.7)
	470,150	21,880 (4.7)	447,970 (95.3)
Non-par switches:			
<i>Auditor change <u>to</u> Big 5/4 1999-2003</i>		(9,357)	9,357
<i>Auditor change <u>from</u> Big 5/4 1999-2003</i>		<u>6,532</u>	<u>(6,532)</u>
		(2,825)	2,825
Audit fees in 2003	470,150	19,055 (4.1)	451,095 (95.9)

Notes: 1. The number (£000) of auditor changes to Big 5/4 is as follows: 1999 = 26 (2,423); 2000 = 22 (1,409); 2001 = 18 (1,934); 2002 = 21 (1,795); 2003 = 12 (1,796).  
2. The number (£000) of auditor changes from Big 5/4 is as follows: 1999 = 17 (906); 2000 = 9 (1,149); 2001 = 23 (1,128); 2002 = 33 (1,603); 2003 = 21 (1,746).

**Table 7: Auditor market share in 2003 (based on audit fees) by industry sector**

Sector	Mkt Cap (£bn)	No. of Cos	PwC %	KPMG %	DT %	EY %	Big 4 %	BDO %	GT %	BT %	RR %	PKF %	MS %	Top-10 %	Others %	
Resources																
Mining	57,258	31	19.4	30.1	36.4	11.9	97.7	0.0	1.3	0.1	0.0	0.4	0.2	99.8	0.2	
Oil & Gas	243,152	31	92.0	0.1	1.6	5.0	98.7	0.5	0.1	0.1	0.4	0.0	0.0	99.7	0.3	
Basic Industries																
Chemicals	19,110	20	42.6	50.6	4.4	0.8	98.4	0.5	0.3	0.0	0.0	0.2	0.0	99.3	0.7	
Cons. & Build. Mat.	37,924	71	32.5	31.4	16.2	15.2	95.2	0.2	0.8	0.2	0.8	0.0	0.5	97.7	2.3	
Forestry & Paper	1,563	3	4.9	95.1	0.0	0.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	
Steel & Oth. Metals	3,158	4	94.6	1.4	3.6	0.0	99.6	0.0	0.0	0.0	0.0	0.0	0.0	99.6	0.4	
General Industrials																
Aerospace & Defence	71,062	13	34.8	53.0	9.6	2.1	99.6	0.0	0.0	0.0	0.0	0.0	0.0	99.6	0.4	
Diversified Industrials	197,192	4	15.3	78.8	0.0	0.0	94.1	0.0	0.0	0.0	0.0	0.0	0.0	94.1	5.9	
Elect. & Elect'l Equip.	13,478	46	5.1	10.6	19.1	53.6	88.4	1.1	7.3	0.6	0.5	0.3	0.0	98.2	1.8	
Engin. & Machinery	32,952	64	18.0	37.3	25.4	15.2	95.8	1.2	0.3	0.0	0.3	0.0	0.9	98.5	1.5	
Cyclical																
Automobiles	41,041	20	77.3	10.6	4.7	2.5	95.1	1.3	3.2	0.3	0.1	0.0	0.0	100.0	0.0	
Housing Gds & Textiles	4,297	52	54.1	18.4	10.3	4.4	87.2	0.2	2.7	1.1	1.6	0.4	0.0	93.1	6.9	
Non-Cyclical																
Beverages	64,621	9	27.3	60.9	0.0	10.4	98.7	0.0	0.4	0.7	0.0	0.0	0.0	99.9	0.1	
Food Prod. & Process.	43,481	30	57.1	17.2	21.6	2.7	98.5	0.2	0.2	0.1	0.0	0.5	0.0	99.6	0.4	
Health	34,224	41	45.0	18.5	27.0	4.1	94.6	0.0	1.0	1.3	2.2	0.2	0.0	99.2	0.8	
Person. Care & House.	15,526	3	0.0	14.0	81.9	0.0	95.9	0.0	0.0	0.0	0.0	0.0	0.0	95.9	4.1	
Pharma. & Biotech.	187,309	38	62.6	28.8	5.7	0.5	97.5	0.6	1.2	0.3	0.3	0.0	0.0	100.0	0.0	
Tobacco	94,614	3	100.0	0.0	0.0	0.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	
Cyclical Services																
General Retailers	63,140	68	49.0	13.3	22.0	6.3	90.6	7.8	0.8	0.0	0.0	0.0	0.2	99.3	0.7	
Leisure & Hotels	30,927	88	20.3	20.9	15.6	32.0	88.8	4.9	1.6	2.2	0.4	0.2	0.0	98.1	1.9	
Media & Entertainment	62,865	99	35.7	6.1	41.3	11.7	94.8	0.7	1.1	2.2	0.0	0.4	0.0	99.3	0.7	
Support Services	38,866	149	36.2	25.6	17.1	16.7	95.6	1.1	0.7	0.4	0.5	0.6	0.3	99.1	0.9	
Transport	27,054	38	31.9	22.1	15.0	30.5	99.5	0.0	0.1	0.1	0.0	0.0	0.0	99.8	0.2	
Non-Cyclical Services																
Food & Drug Retailers	33,453	16	66.3	17.6	0.0	12.0	95.9	2.7	0.0	0.6	0.0	0.0	0.0	99.2	0.8	
Telecom. Services	163,225	19	24.2	39.3	35.2	0.8	99.5	0.0	0.0	0.0	0.0	0.2	0.0	99.7	0.3	
Utilities																
Electricity	14,995	6	55.8	37.3	0.0	5.3	98.5	0.0	0.0	0.0	0.0	1.5	0.0	100.0	0.0	
Utilities - Other	31,251	10	86.8	0.8	5.8	5.8	99.2	0.0	0.0	0.0	0.0	0.0	0.0	99.2	0.8	
Financials																
Banks	377,346	10	42.6	24.3	33.2	0.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	
Insurance	35,593	21	63.7	14.0	6.8	8.8	93.3	0.0	1.9	0.3	0.0	1.0	0.0	96.5	3.5	
Life Assurance	38,290	8	10.3	50.8	2.4	36.5	100.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	
Real Estate	26,178	76	23.7	24.7	37.4	2.9	88.8	3.4	1.4	2.0	0.0	0.0	0.2	95.9	4.1	
Speciality & Oth. Fin	54,951	125	28.1	11.5	24.7	29.0	93.2	1.5	1.2	0.3	0.3	0.2	1.1	97.8	2.2	
Info. Technology																
IT Hardware	6,210	28	13.7	6.6	18.5	53.4	92.2	1.6	0.3	2.5	1.6	0.9	0.5	99.5	0.5	
Soft. & Comp. Services	71,410	142	31.2	20.4	25.4	11.9	88.8	3.3	3.0	2.2	0.8	0.3	0.4	98.9	1.1	
Summary																
No. of sectors where:																
market share ≥ 50%			11	6	1	2	20									
market leader			18	8	4	4	34									
≥ 50% & market leader			11	6	1	2	20									
Total cos. in 34 sectors		1,386														

Notes: 1. Market shares of 50% or greater are highlighted in bold; leaders are underlined.

2. PwC= PricewaterhouseCoopers; KPMG= KPMG; DT= Deloitte; EY= Ernst & Young; BDO= BDO Stoy Hayward; GT= Grant Thornton; BT= Baker Tilly; RR= Robson Rhodes; PKF= PKF; MS= Moore Stephens.



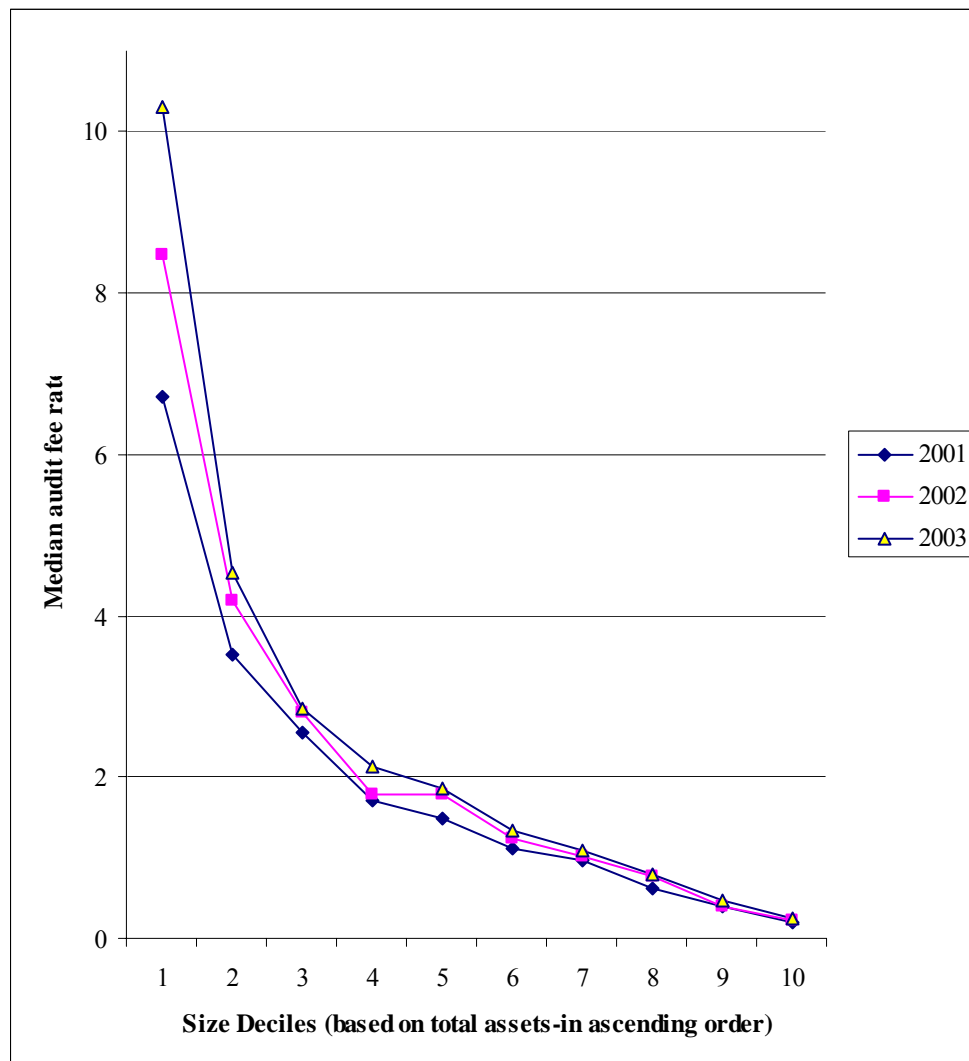
**Table 8: Analysis of former Andersen clients - successor auditors, audit and NAS fees**

Successor <sup>1</sup>	Panel A		Panel B Aggregate AUDIT fees (£000)			Panel C Audit fees per £000 total assets			Panel D Aggregate NAS fees (£000)			Panel E Aggregate TOTAL fees (£000)		
	No. of audits	%	AA	New auditor	% Change	Median AA	Median New auditor	Median % Change <sup>4</sup>	AA	New auditor	% Change	AA	New auditor	% Change
<b>DT<sup>2</sup></b>	93	74.4	19,471	20,449	5.0	0.93	1.04	7.2%	49,355	39,300	-20.4	68,826	59,749	-13.2
<b>PWC</b>	9	7.2	2,711	2,535	-6.5	1.08	1.34	-9.3	1,418	2,103	48.3	4,129	4,638	12.3
<b>EY</b>	6	4.8	3,818	4,264	11.7	0.87	0.86	6.3%	3,200	973	-69.6	7,018	5,237	-25.4
<b>KPMG</b>	6	4.8	1,211	1,062	-12.3	1.18	0.73	-23.9	2,063	2,544	23.3	3,274	3,606	10.1
<i>B4 excl DT Median change in fees across B4 excl DT<sup>3</sup></i>	<i>21</i>	<i>16.8</i>	<i>7,740</i>	<i>7,861</i>	<i>1.6</i> <i>0.0</i>	<i>0.99</i>	<i>0.94</i>	<i>-6.7</i>	<i>6,681</i>	<i>5,620</i>	<i>-15.9</i> <i>0.0</i>	<i>14,421</i>	<i>13,481</i>	<i>-6.5</i> <i>1.2</i>
<i>All B4 Median change in fees across B4<sup>3</sup></i>	<i>114</i>	<i>91.2</i>	<i>27,211</i>	<i>28,310</i>	<i>4.0</i> <i>0.0</i>	<i>0.95</i>	<i>0.99</i>	<i>3.0</i>	<i>56,036</i>	<i>44,920</i>	<i>-19.8</i> <i>-15.1</i>	<i>83,247</i>	<i>73,230</i>	<i>-12.0</i> <i>-1.9</i>
<i>All non-B4 Median change in fees across non-B4<sup>3</sup></i>	<i>11</i>	<i>8.8</i>	<i>366</i>	<i>322</i>	<i>-12.0</i> <i>-10.0</i>	<i>2.31</i>	<i>2.35</i>	<i>1.7</i>	<i>399</i>	<i>211</i>	<i>-47.1</i> <i>0.0</i>	<i>765</i>	<i>533</i>	<i>-30.3</i> <i>-28.4</i>
<b>All former AA clients Median change in fees across all AA clients<sup>3</sup></b>	<b>125</b>	<b>100</b>	<b>27,577</b>	<b>28,632</b>	<b>3.8</b> <b>0.0</b>	<b>1.00</b>	<b>1.02</b>	<b>2.4</b>	<b>56,435</b>	<b>45,131</b>	<b>-20.0</b> <b>-13.2</b>	<b>84,012</b>	<b>73,763</b>	<b>-12.2</b> <b>-3.9</b>

Notes:

1. AA= Andersen; DT= Deloitte Touche; PWC= PricewaterhouseCoopers; EY= Ernst & Young; KPMG= KPMG;  
non-B4 successor auditors are BDO Stoy Hayward (4); Robson Rhodes (3); Nexia Audit (2); Grant Thornton (1); and Wilkins Kennedy (1).
2. For DT, the median change in audit fees, NAS and total fees were 0.0%, -17.1% and -6.6% respectively.
3. This is the median across the 21, 114, 11, 125 former AA clients audited respectively by 'B4 excluding DT', B4, non-B4 and overall.
4. This is the median % change in audit fee rate across the group of new auditor clients rather than the change in median audit fee rate.

**Figure 1: Effects of client size on audit fee rate**



*Note: 1. Audit fee rate = £audit fee per £000 total assets audited*